

the qualified matching contributions taken into account under the ADP test for the plan year are added together and the sum is divided by the employee's compensation for the same period. The proposed regulations under section 401(m) would provide parallel restrictions on QNECs taken into account in ACP testing, and a QNEC cannot be taken into account under both the ADP and ACP test (including for purposes of determining the representative contribution rate). As discussed more fully below, the proposed regulations would also have a limitation on targeting matching contributions, which would limit the extent to which QMACs can be targeted as a means of avoiding the restrictions on targeted QNECs.

The proposed regulations would also implement a prohibition against double counting of QNECs that was set forth in Notice 98-1. Generally, QNECs used in an ADP or ACP test, used to satisfy the safe harbor under section 401(k), or under a SIMPLE 401(k) plan can not be used again to demonstrate compliance with another test under section 401(k)(3) or 401(m)(2). For example, double counting could arise when QNECs on behalf of NHCEs are used to determine the ADP under current year testing in year 1 and then, if the employer elected prior year testing, are used again in year 2 to determine the ADP of NHCEs. However, unlike Notice 98-1, these proposed regulations would not contain the additional limitations on double counting elective contributions or matching contributions that were moved between the ADP and ACP tests.

D. Correction

Section 401(k)(8)(C), as amended by the SBIPA, provides that, for purposes of correcting a plan's failure to meet the nondiscrimination requirements of section 401(k)(3), distribution of excess contributions is made on the basis of the amount of the contributions by, or on behalf of, each HCE. The proposed regulations would implement this correction procedure in the same manner as set forth in Notice 97-2. Thus, the total amount of excess contributions is determined using the rules under the existing final regulations (*i.e.*, based on high percentages). Then that total amount is apportioned among the HCEs by assigning the excess to be distributed first to those HCEs who have the greatest dollar amount of contributions taken into account under the ADP test (as opposed to the highest deferral percentage). If these amounts are distributed or recharacterized in accordance with these regulations, the plan complies with the ADP test for the

plan year with no obligation to recalculate the ADP test.

The proposed regulations would provide a special rule for correcting through distribution of excess contributions in the case of an HCE who participates in multiple plans with CODAs. In that case, the proposed regulations would provide that, for purposes of determining which HCE will be apportioned a share of the total excess contributions to be distributed from a plan, all contributions in CODAs in which such an HCE participates are aggregated and the HCE with the highest dollar amount of contributions will apportioned excess contributions first. However, only actual contributions under the plan undergoing correction—rather than all contributions taken into account in calculating the employee's ADR—may be distributed from a plan. If the high dollar HCE's actual contributions under the plan are insufficient to allow full correction, then the HCE with the next highest dollar amount of contributions is apportioned the remaining excess contributions. If additional correction is needed, this process is repeated until the excess contributions are completely apportioned. This correction mechanism is applied independently to each CODA in which the HCE participates. If correction is needed in more than one CODA, the ADRs of HCEs who have received corrective distributions under the other arrangements are not recalculated after correction in the first plan.

The proposed regulations would generally follow the rules in the existing regulations on the determination of net income attributable to excess contributions. The existing regulations provide for a reasonable determination of net income attributable to an excess contribution, but do not specify which contribution within the plan year is to be treated as the excess contribution to be distributed. This provision would be retained in the proposed regulations along with the existing alternative method of determining the net income, which approximates the result that would apply if the excess contribution is made on the first day of the plan year. However, to the extent the employee is or will be credited with allocable gain or loss on those excess contributions for the period after the end of the plan year (the gap period), the proposed regulations would now require that income be determined for that period. As under the existing regulations, the determination of the income for the gap period could be based on the income determined using the alternative method for the aggregate of the plan

year and the gap period or using 10% of the income for the plan year (determined under the alternative method) for each month in the gap period.

The proposed regulations would permit the recharacterization of excess contributions in a manner that generally follows the existing regulations. However, the year the employee must include the recharacterized contribution in current income has been changed to match the year that the employee would have had to include the excess contribution in income, had it been distributed. Thus, if the recharacterized amount is less than \$100, it is included in gross income in the year that it is recharacterized, rather than the year of the earliest elective contributions for the employee.

The proposed regulations would retain the rules in the existing regulations regarding the timing and tax treatment of distributions of excess contributions, coordination with the distribution of excess deferrals and the treatment of matches attributable to excess contributions.

E. Special Rules Relating to Prior Year Testing

The proposed regulations would generally follow the rules set forth in Notice 98-1 regarding prior year testing, including the limitations on switching from current year testing to prior year testing. However, the proposed regulations would provide that a plan is permitted to be inconsistent between the choice of current year testing method and prior year testing method, as applied for ADP purposes and ACP purposes. In such a case, any movement of elective contributions or QMACs between the ADP and ACP tests (including recharacterization) would be prohibited.

The proposed regulations would generally incorporate the rules set forth in Notice 98-1 relating to plan coverage changes in the case of a plan using prior year testing. Thus, in the case of a plan that uses prior year testing and experiences a plan coverage change affecting more than 10% of the NHCEs, the ADP of the NHCEs would generally be determined as the weighted average of the ADP of the NHCEs of the plans in which the NHCEs participated in the prior year. The definition of plan coverage change includes changes in the group of eligible employees under a plan resulting from the establishment or amendment of a plan, a plan merger or spin-off or a change in the way plans are combined or separated under the section 410(b) rules. The definition under the proposed regulations would