

for an eligible NHCE, 5% in ADP testing and 5% in ACP testing, without regard to how many NHCEs receive QNECs.

In addition, to prevent an employer from using targeted matching contributions to circumvent the limitation on targeted QNECs, the proposed regulations would provide that matching contributions are not taken into account in the ACP test to the extent the matching rate for the contribution exceeds the greater of 100% and 2 times the representative matching rate. Paralleling the rule to limit targeted QNECs, the representative plan matching rate is the lowest matching rate for any eligible employee in a group of NHCEs that consists of half of all eligible NHCEs in the plan for the plan year (or the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year, if greater). For this purpose, the matching rate is the ratio of the matching contributions to the contributions that are being matched, and only NHCEs who make elective deferrals or employee contributions for the plan year are taken into account.

The proposed regulations would set limits on the use of elective contributions in the ACP test that are in addition to the rules in the existing regulations under which elective contributions may be taken into account for the ACP test only to the extent the plan satisfies the ADP test, determined by including such elective contributions in the ADP test. Under the new rule, the proposed regulations would provide that elective contributions under a plan that is not subject to the ADP test, such as a plan that uses the safe harbor method of section 401(k)(12) or a contract or arrangement subject to the requirements of section 403(b)(12)(A)(ii), may not be taken into account for the ACP test. In the absence of this prohibition, contributions that are not properly considered "excess" could be taken into account under the ACP test.

The provisions of these proposed regulations regarding correction of excess aggregate contributions, including allocation of excess aggregate contributions and determination of allocable income, would generally be consistent with the provisions of the proposed regulations under section 401(k). These proposed regulations continue the provisions of the current regulations regarding correction through distribution of vested matching contributions and forfeiture of unvested matching contributions. Similarly, the proposed regulations reflect the provisions of section 411(a)(3)(G) which

permit the forfeiture of a matching contribution made with respect to an excess deferral, excess contribution, or excess aggregate contribution. This provision is necessary to allow forfeiture of matching contributions that would otherwise violate section 401(a)(4).

9. Safe Harbor Section 401(m) Plans

Section 401(m)(11) provides a design-based safe harbor method of satisfying the ACP test contained in section 401(m)(2). Under section 401(m)(11), a defined contribution plan is treated as satisfying the ACP test with respect to matching contributions if the plan satisfies the ADP safe harbor of section 401(k)(12) and matching contributions are not made with respect to employee contributions or elective contributions in excess of 6% of an employee's compensation. For a plan that satisfies the ADP safe harbor using a 3% nonelective contribution, two additional requirements that apply to a plan that satisfies the ADP safe harbor using matching contributions also apply: (1) The rate of an employer's matching contribution does not increase as the rate of employee contributions or elective deferrals increase; and (2) the matching contribution with respect to any HCE at any rate of employee contribution or elective deferral is not greater than with respect to any NHCE. In addition, the ratio of matching contributions on behalf of an HCE to that HCE's elective deferrals and employee contributions for a plan year cannot be greater than the ratio of matching contributions to elective deferrals or employee contributions that would apply with respect to any NHCE who contributes (as an elective deferral or employee contribution) the same percentage of safe harbor compensation for that plan year.

Section 1.401(m)-3 of these proposed regulations, which sets forth the requirements for these plans, would generally follow the rules set forth in Notice 98-52 and Notice 2000-3. These proposed regulations would clarify that, for purposes of determining whether an HCE has a higher rate of matching contributions than any NHCE, any NHCE who is an eligible employee under the safe harbor CODA must be taken into account, even if the NHCE is not eligible for a matching contribution. This means that a plan with a provision which limits matching contributions to employees who are employed on the last day of the plan year will not be able to satisfy the ACP safe harbor, since a NHCE who is not eligible to receive a matching contribution on account of the last day requirement will nonetheless be

taken into consideration in determining whether the plan satisfies section 401(m)(11)(B)(iii). The proposed regulations also include the requirement that matching contributions made at the employer's discretion with respect to any employee cannot exceed a dollar amount equal to 4% of the employee's compensation and that a safe harbor plan must permit all eligible NHCEs to make sufficient elective contributions (or employee contributions, if applicable) to receive the maximum matching contribution provided under the plan.

The proposed regulations would provide a special rule for satisfying section 401(m)(11)(B)(iii) in the case of an HCE who participates in two or more plans that provide for matching contributions. Under this rule, a plan will not fail to satisfy the requirements of section 401(m)(11)(B)(iii) merely because an HCE participates during the plan year in more than one plan that provides for matching contributions, provided that the HCE is not simultaneously an eligible employee under two plans that provide for matching contributions maintained by an employer for a plan year; and the period used to determine compensation for purposes of determining matching contributions under each such plan is limited to periods when the HCE participated in the plan. In such a case, an HCE can transfer from a plan with a more generous matching schedule to an otherwise safe harbor section 401(m) plan (for example, as a result of switching jobs within the controlled group) without causing the safe harbor plan to violate section 401(m)(11). However, the plan which is not the safe harbor plan will still have to aggregate matching contributions for the HCE under the rule set forth in section 401(m)(2)(B).

The safe harbor in section 401(m)(11) does not apply to employee contributions. Consequently, a plan that provides for employee contributions and matching contributions must satisfy the ACP test even though the matching contributions satisfy the safe harbor requirements for section 401(m)(11). However, the proposed regulations would also adopt the position in Notice 98-52 that the ACP test is permitted to be applied by disregarding all matching contributions with respect to all eligible employees. If the ADP safe harbor using matching contributions is satisfied but the ACP safe harbor is not satisfied, the proposed regulations would adopt the position in Notice 98-52 that the ACP test is permitted to be applied disregarding matching contributions for