# THE NEW YORK UNIVERSITY
# 58TH INSTITUTE ON FEDERAL TAXATION – EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION
# 2000

Reprinted from the proceedings of the
New York University 58th Institute on Federal Taxation –
Employee Benefits and Executive Compensation.
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Published by Matthew Bender & Company, Inc.
New York, New York.

# CHAPTER 2

# 401(k) Safe Harbors Work For Small Business

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* The authors would like to express their appreciation to Ms. Katherine M. Glenn, Ms. Jean Walker and Mr. Brandon D. Hadley for their efforts in preparing this article.

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This chapter will examine the history, the present and the future of 401(k) safe harbors. The technical rules governing 401(k) safe harbors will be explained in detail and some flexible, yet simple, small business 401(k) safe harbor plan designs will be analyzed.

## § 2.01 THE GENESIS OF THE 401(k) SAFE HARBORS

Stay clear of 401(k) plans! This was the advice given to many small businesses not so long ago. They were considered too complicated and costly for a small company. Clearly, a small business could not properly administer a 401(k) plan by itself. The amount of 401(k) contributions[1] that could be made by the highly compensated employees ("HCEs")[2] was dependent upon the

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[1] A legal fiction was employed in order to allow 401(k) contributions to be tax deductible under the Internal Revenue Code. Even though contributions were made directly from an employee's salary (the cash or deferred election), these contributions were deemed to be made by the employer. This fiction has caused the 404(c) deduction problem which now exists because employee 401(k) contributions are included in the overall 15% deduction limit. To illustrate the problems inherent in including 401(k) contributions in this limitation — consider a company with a profit sharing/401(k) plan which decides to make a 15% profit sharing contribution at the end of the year. All 401(k) contributions made during the year must now be returned to the employees. The tax and pension legislation recently passed in the U.S. House of Representatives as the "Small Business Tax Fairness Act," and the Senate as part of the Minimum Wage Amendment to "The Bankruptcy Reform Act of 2000," would fix this problem by eliminating 401(k) contributions from the deduction limit. H.R. 3081, 106th Cong. (2000); S. 625, 106th Cong. (2000) (part of the Minimum Wage Amendment, S. Amdt. 2547). Unfortunately, at present this legislation is opposed by the President.

[2] I.R.C. §414(q) defines an HCE as any employee who (A) was a 5% owner at any time during the year or the preceding year, or (B) for the preceding year — (i) had compensation from the employer in excess of $80,000, and (ii) if the employer elects the application of this clause for such preceding year, was in the

amount contributed by the non-highly compensated employees ("NHCEs") calculated under a formula set forth in Section 401(k) of the Internal Revenue Code[3] ("IRC"). Because of the complexities inherent in performing the anti-discrimination tests imposed by Section 401(k) and the regulations thereunder, (referred to as the "ADP tests"),[4] a competent third party administrator was virtually required if the plan was to be kept in operational conformity with the law.

Back in the mid 1980's, several key associations in the retirement plan area[5] attempted to simplify the discrimination rules governing 401(k) plans in hopes of increasing employer sponsorship of the plan. It was already understood that employees valued the chance to participate in 401(k) plans. What was not entirely clear then, but is now, was the opportunity these plans provided participants to learn how to invest in mutual funds and in some cases, equities and bonds. It is the authors' belief that the 401(k) plan, more than any other event in recent history, opened up the stock market to the average American.

Further, experts in the retirement plan area began to appreciate the impact of the forced savings feature of a company sponsored retirement plan. This forced savings has proved essential to retirement accumulation for a great many participants.[6] Because the

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top-paid group of employees for such preceding year. The Secretary shall adjust the $80,000 amount under subparagraph (B) at the same time and in the same manner as under §415(d), except that the base period shall be the calendar quarter ending September 30, 1996.

[3] I.R.C. §401(k) (CCH 2000).

[4] I.R.C. §401(k)(3)(A)(ii) (as amended 1995).

[5] The Association of Private Pension and Welfare Plans ("APPWP"), the Small Business Council of America ("SBCA"), the Profit Sharing/401(k) Council, and the U.S. Chamber of Commerce were the leaders in developing and promoting the idea of 401(k) safe harbors. It was embraced by the delegates to the White House Conference on Small Business in 1986 and in 1995.

[6] The company sponsored retirement plan must be distinguished from a company sponsored IRA program such as the SIMPLE or a SEP. SIMPLE plans and SEPs are based on an IRA framework and as such provide unlimited employee access to the funds in the IRA, albeit penalties are imposed for early withdrawals. Even though there does not appear to be any well documented study which indicates the extent to which employees withdraw funds from IRAs, anecdotal evidence indicates that funds are, in fact, freely withdrawn from these company sponsored IRA vehicles. This is why many experts who are interested in promoting retirement

assets of a retirement plan are held in a trust,[7] employees lose easy access to their account balances. When funds are left alone inside a retirement plan so that tax free compounding can work its magic, employees often end up with significant accumulation for retirement. Two old adages seem to apply here. The first, "out of sight, out of mind," certainly rings true in the retirement plan area. Employees do not miss the funds that are accumulating — 401(k) funds are removed from their pay prior to receipt. The discipline imposed by saving every paycheck becomes painless and easy. The second, "no matter what size my paycheck, I can spend it," also seems to hold true. The data show that Americans are poor savers and excellent spenders. It is the authors' belief that the single greatest savings vehicle available to many Americans today is the 401(k) plan.

Not only are the employees' 401(k) contributions locked up in the plan, but so are contributions made by employers to a qualified retirement plan (as contrasted to a SEP or a SIMPLE). Employer contributions can only be accessed by loans, if provided for in the plan, and sometimes by hardship distributions, if provided for in the plan. Loans are carefully regulated by law and require a written note, quarterly amortization of principal and interest and are often paid back by payroll deduction.[8] Some plans do not allow loans at all, and some only allow them in the event of a hardship. A relatively small number of plans also allow hardship distributions. (Unlike a loan, a hardship distribution is not paid back to the plan.) The standard for a hardship distribution is very strong — a hardship distribution is generally only granted if the distribution is necessary to pay for expenses of medical care, the purchase of a principal residence for the employee, tuition for post-secondary education or to prevent the eviction of the employee from his or her principal residence or foreclosure on the mortgage of that residence.[9]

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savings for small business employees believe that the 401(k) safe harbor plan is a superior vehicle to the SIMPLE plan.

[7] Only qualified retirement plans which are entirely funded by life insurance products are allowed to dispense with a trust. These plans also effectively lock up the retirement plan assets so that funds can only be accessed by loans, if available under the plan, or by hardship distributions, if available by the plan.

[8] I.R.C. §72(p)(2) (CCH 2000).

[9] Treas. Reg. §1.401(k)-1(d)(2)(iv)(A) (as amended 1995).

These retirement plan associations believed that if the 401(k) anti-discrimination tests were eliminated, that many more companies, particularly small businesses, would choose to sponsor these valuable retirement plans. These associations, which have extensive expertise in retirement plan law, contended that the ADP tests were simply unnecessary because the amount that could be contributed to a 401(k) account was relatively small (in 1987, the amount was $7,000).

Even though this argument should probably have carried the day, it was countered by groups which have little technical expertise but represent the powerful groups comprised of the elderly and primarily union employees. These groups maintained that because employers had to "beef up" contributions for the NHCEs when the ADP tests failed, or alternatively, had to return the "excess" 401(k) contributions to some or all of the HCEs, these tests therefore performed a valid function. Since at least some of the time the NHCEs received additional employer contributions in order for the plan to satisfy the ADP tests, these groups thought that retaining the complicated tests would be worthwhile.

As an aside, there has been an interesting tension between these opposing groups for at least a decade, if not two. The groups that represent employers and the voluntary retirement system, particularly those who believe that increasing small business coverage is essential, would simplify the rules and increase incentives to bring additional employers into the voluntary retirement plan system. Those who represent the elderly and primarily union employees do not seem to care much for increasing sponsorship of the plans by companies, particularly small companies; rather they look to what the HCEs receive as contributions versus the NHCEs in the existing plan universe and work to increase the amounts going to the NHCEs. Little weight is given to increasing coverage.[10] In the past,

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[10] This theory held sway during the 1970's and early 80's in the development of our qualified retirement plan policy by Congress. In part driven by the desire for revenue and in part to reduce what HCEs could receive from the system while simultaneously increasing what the NHCEs would receive, additional burdens and alarming complexity were added to the system. By the mid 80's, the data showed that plan terminations were substantially increasing and new plan formation was stagnant at best. Small business was leaving the qualified retirement plan area in droves. It wasn't until the mid-80's that Congress began to realize that extra rules, extra burdens and extra costs do not incentivize small business to join the retirement

Treasury has sided with the groups not concerned with increasing coverage, but in the last several years, it has become apparent that Treasury and the Administration are beginning to understand how increased sponsorship of retirement plans, particularly by small businesses, will truly promote retirement security for millions of Americans.[11]

Because of the opposition to simply dropping the 401(k) tests, the concept of a 401(k) safe harbor was developed. The idea was that a company could voluntarily choose to dispense with the ADP tests by adopting a safe harbor. If it did so, a company would lose some plan design flexibility and would be required to either make a significant matching contribution or a nonelective contribution (in reality a profit sharing contribution). In return, the plan would be easier and cheaper to administer.

Even though the safe harbor did require significant matching contributions (see the technical discussion below) or a three percent nonelective contribution, initially even this concept was opposed by the groups representing primarily the elderly and union employees as making it too "easy" for businesses to avoid the ADP tests. Eventually, however, the simplicity of the concept, coupled with the realization that significant employer contributions were required, won the day and the safe harbors were passed in the Small Business Job Protection Act of 1996 ("SBJPA"),[12] effective for 1999 plan years.[13] Thus, if a company chose to elect the 401(k)

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plan system. *See* Paula A. Calimafde and Julie A. Schejbal, *The State of Small Business Retirement Plans: 25 Years After ERISA, in* NYU PROCEEDINGS OF THE FIFTY-SEVENTH INSTITUTE ON FEDERAL TAXATION, EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION 2-1, 2-11 through 2-29 (1999).

[11] The Treasury and the U.S. SBA, Office of Advocacy worked with many small business groups, including the SBCA, the National Federation of Independent Businesses ("NFIB"), the Small Business Legislative Council ("SBLC") and the U.S. Chamber of Commerce at the White House Conference on Small Business in 1995 to develop the concept of the SIMPLE plan. As will be discussed in more detail below, the Treasury and the Office of Advocacy, U.S. SBA worked with a number of small business groups to develop the ideas set forth in IRS Notice 2000-3 whose intent is clearly to increase sponsorship of the 401(k) safe harbors by small businesses. I.R.S. Notice 2000-3, 2000-4 I.R.B. 413.

[12] Small Business Job Protection Act of 1996, Pub. L. 104–188, 110 Stat. 1755 (codified in scattered sections of 26 U.S.C.).

[13] Special mention must be given to Congressman Rob Portman, Congressman

safe harbor in any given year, no further ADP (and possibly ACP) testing would be required for that year, and every employee — HCE and non-HCE — would be able to contribute up to the maximum 401(k) level in effect that year. (Currently the allowable amount for 401(k) contributions is $10,500.)[14]

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Ben Cardin, Congressman Earl Pomeroy, Congresswoman Nancy Johnson, former Congresswoman Jan Meyers, Senator Bob Graham, Senator Bill Roth, Senator Chuck Grassley, Senator Jim Jeffords, and Senator Kit Bond, among others. These members of Congress and their staff members have worked tirelessly to educate their fellow representatives on the very technical laws governing the retirement plan system and to bring desperately needed reform and simplification to that system. It is no exaggeration to say that their efforts to date have significantly increased the retirement security for many Americans. If the comprehensive retirement plan legislation that has been passed by Congress this year (H.R. 3081 and S. 625) became law, literally millions of Americans would benefit by being able to participate in the retirement system and also receive company contributions.

[14] The legislation recently passed by the Senate as a part of the Bankruptcy Reform Act of 2000 would increase the 401(k) limit up to $15,000, phased in by 2005. The House Small Business Tax Fairness Act would increase this limit up to $14,000 by 2004. Even though one would think no one could object to this relatively small increase in the amount that an employee can contribute to a 401(k) plan, of course, in the pension area, there are those who believe that this increase would only be used by HCEs and because of that should not be adopted. Experts in the field know that quite often NHCEs would contribute more to the 401(k) plan if they could. The typical fact pattern is a two earner couple where only one spouse works for an employer with a 401(k) plan. The couple (both NHCEs) would like to save as much as possible in that plan but are precluded by the $10,500 limitation. It is not unusual for the second spouse to have been out of the work force for some time while raising children. The couple could therefore save significant amounts of this "extra" income.

Even assuming *arguendo*, that more HCEs would take advantage of this provision than NHCEs, (which is debatable) one could effectively argue that with the huge wave of baby boomers getting ready to retire in the next decade (without sufficient savings), that every possible savings vehicle should be encouraged. Many retirement plan experts believe that the current retirement plan system discriminates against highly compensated employees. The amount of compensation that can be taken into account under a retirement plan is limited. I.R.C. §401(a)(17) (CCH 2000). The amount of contributions that can be put into a plan are limited. When social security is taken into account, the picture becomes far more skewed. Social security is basically a defined benefit plan — employees assume no investment risk, it has a cost of living adjustor and they can't outlive it. It appears that absent a large spending pattern, the average American will need to have approximately 70% of his or her regular income available for retirement. Of course, the smaller this number is, the greater the impact of social security. For instance, if social security is replacing 35 to 40% of this amount which is guaranteed to continue

It was perceived from the start that these safe harbors would be of most interest to smaller businesses. For larger business entities, the required contributions were considered too strong, the accelerated vesting and loss of flexibility undesirable and the cost of changing employee communications too expensive.

## § 2.02 INTERACTION OF SMALL BUSINESS 401(k) PLANS AND THE TOP-HEAVY RULES

There can be no meaningful discussion of small business plans and the 401(k) plan rules, particularly the safe harbor rules, without taking into account the interaction of the top-heavy rules. Many people are surprised to learn that most small businesses[15] are subject to harsher rules in the qualified retirement plan system than larger entities. These extra burdens are contained in the so-called top-heavy rules set forth in IRC Section 416. The vast majority of all plans sponsored by privately held companies are top-heavy due to the simple mathematical test set forth in Section 416.[16]

A top-heavy plan is one in which the combined account balances (in the context of a defined contribution plan) for the "key employees" exceed 60% of the combined account balances for all employees under the plan.[17] A key employee can be, but is not necessarily,

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throughout the entire life expectancy, the non-highly compensated employee will have to save a significantly smaller amount in a retirement plan to make up the short fall than the highly compensated individual who is having far less of his or her income replaced by social security. Thus, the limits imposed on the highly compensated employees by the retirement plan system make it much harder for them to save adequately for retirement.

[15] For purposes of this chapter, a "small business" is defined as a business with 100 or fewer employees.

[16] Interestingly, many advisors think only small business plans can be top-heavy, but mid-size privately owned companies with 100 to 200 employees can also become top-heavy if there is significant turn over amongst the non-key employees while not much with the key employees.

[17] The reason why so many small businesses (or better, privately owned businesses) are top-heavy is because these companies often have a significant number of key employees and relatively few non-key employees. Whereas a large enterprise resembles a pyramid with a small number of key employees, a larger amount of management employees and a wide base of staff employees, a privately held company is almost a reverse pyramid or rectangular in employment structure. In a small business the largest group of employees may be the key employees. This simply cannot occur in a large enterprise. One of the authors can recall a

the same as a HCE. A key employee is an employee who at any time during the plan year or any of the four preceding plan years is (i) an officer receiving more than 50% of the dollar amount specified in Section 415(b)(1)(A) (currently $30,000), (ii) one of the top ten employees who have annual compensation of more than the dollar amount specified in section 415(c)(1)(A) and who own the largest interests in the employer, (iii) a 5% owner, or (iv) a 1% owner with annual compensation of more than $150,000.[18] Aside from a myriad of complicated rules and record-keeping which accomplish little substantively, but impose significant and costly burdens on small business, the top-heavy rules do impose slightly accelerated vesting schedules on plan contributions and minimum required contributions for non-key employees. A top-heavy plan must vest benefits at least as rapidly as either: (i) no vesting for the first two years of service and 100% vesting upon the completion of the third year of service (referred to as "3 year cliff vesting") or (ii) no vesting for the first year of service and 20% vesting upon completion of each year of service thereafter (referred to as "6 year graded vesting"). The counterpart to these vesting schedules for larger entities is 5 year cliff vesting and 7 year graded vesting.

In a top-heavy defined contribution plan, the employer must make a plan contribution equal to 3% of compensation for every non-key employee who is a participant in the plan, unless the highest percentage contribution for a key employee is less than 3%, in which case the highest actual percentage for any key employee becomes the minimum contribution.[19] Thus, if no contributions are

group of women who came up to her after a lecture which she presented in Albuquerque, New Mexico. Ten women had decided to join together to form an art enterprise. They explained to the author that they each owned 10% of the company and that in their first year, they hoped to make $25,000 each. They asked whether they would be considered key employees or HCEs. Of course, the absurd answer is that all ten are deemed to be both key employees and HCEs. They could not sponsor a plan and make a contribution for themselves (even in an employee pay-all 401(k) plan) without making the top-heavy contributions for their staff employees. This they could not afford to do. (This company might have been able to sponsor a SIMPLE, but it is doubtful it could have afforded even the required matching contributions).

[18] I.R.C. §416(i) (CCH 2000).

[19] There is also a substantial required minimum contribution for a top-heavy defined benefit plan which is not applicable to our topic.

made for the key employees, then no top-heavy minimum contributions are required in the defined contribution context.

One of the peculiarities of the top-heavy rules is a rule which operates to discourage small businesses from allowing employees to immediately enter the 401(k) portion of a top-heavy plan even though the employees want to be able to contribute immediately. In the normal retirement plan world (that is outside the top-heavy rules), allowing immediate entry into the 401(k) portion of a plan would not cost the company any additional company contributions. If a non-key employee "benefits" in a top-heavy plan, however, then that employee must receive the 3% top-heavy minimum even if he or she is not eligible to receive any other employer contribution (i.e, a profit sharing contribution or a match contribution).[20] For example, if a small business sponsored a top-heavy profit sharing/ 401(k) combination plan which had a 1 year wait for eligibility for the profit sharing portion and immediate eligibility for the 401(k) portion, many practitioners believe that every non-key employee is entitled to receive the 3% top-heavy contribution regardless of whether the employee chose to make 401(k) contributions. Other practitioners believe that only the non-key employees who actually participate in the 401(k) option are entitled to receive the 3% top-heavy contribution. Unfortunately, as is the case with many of the obscure top-heavy rules, there are many advisors who are not even aware of this issue. Because of this requirement, knowledgeable small business retirement plan advisors tell their clients to have a one year wait for both portions of the plan. This hurts the employees by delaying their chance to save in a tax free environment for a year.[21]

Perhaps the most unfair rule in the context of top-heavy 401(k) plans was imposed on small business through the regulations.[22] This rule converts key employee 401(k) contributions into employer contributions, thus triggering the top-heavy minimum contributions. This is patently unfair to small business. In effect, the actual working of this rule precludes key employees from making 401(k)

[20] Treas. Reg. §1.416-1, Q & A M-7 and M-10 (as amended in 1992); ERISA §3(7).

[21] This rule would not be changed by the comprehensive retirement plan legislation passed this year by the House and the Senate.

[22] Treas. Reg. §1.416-1, Q & A M-20 (as amended in 1992).

contributions to an employee pay-all plan even if they would be allowed to do so under the ADP rules. This rule only applies to top-heavy plans and thus applies primarily to privately held companies.[23] In other words, a larger entity can sponsor an employee pay-all plan and all employees, HCEs, keys or otherwise can make employee 401(k) contributions to the plan as allowed by the ADP tests and not trigger any profit sharing contribution by doing so. The very same plan in the small business context triggers a 3% top-heavy contribution for the non-key employees, if the plan is top-heavy.[24]

## § 2.03 1999 — THE 401(k) SAFE HARBOR IN ITS FIRST YEAR OF EXISTENCE

Unfortunately, the interest anticipated by retirement plan experts in the 401(k) safe harbors by small business did not materialize in 1999. A major problem was that IRS did not issue guidance by IRS in Notice 98-52[25] until mid-November, 1998 This Notice made it clear that employers would be required to provide an extensive written notice and commit to the required safe harbor contributions at least thirty days before the beginning of the plan year.

In the real world this translated into requiring that advisors explain the safe harbor options and the company, if it so desired, to elect the safe harbor in writing and provide notice to its employees thirty days prior to the beginning of the plan year. The notice did allow a business electing the safe harbor which had a plan year beginning on or before April 1st, 1999, to satisfy the timing requirement by giving the safe harbor notice for that plan year (with respect to an existing 401(k) plan or a newly established one) on or before March 1st, 1999. In the case of a calendar year

[23] The authors have never been able to come up with an acceptable rationale for this rule.

[24] The comprehensive retirement plan legislation passed by both the House and the Senate, and currently opposed by the President, while doing away with a few of the absurdities contained in the top-heavy rules, retains this rule, as well as the required minimum contributions and the accelerated vesting schedules. These requirements, in addition to the peculiar rules mentioned above, rankle small business owners. The top-heavy rules are one of the primary reasons why small business owners maintain that the qualified retirement plan system discriminates against them and small businesses.

[25] I.R.S. Notice 98-52, 1998-46 I.R.B. 16.

plan, this extended the timing for the notice from December 1st, 1998 to April 1st. Even with this extension, however, there simply was not enough time to get the word out about the safe harbors and to explain their advantages and disadvantages. Moreover, the institutions offering turn-key 401(k) products were either not interested in the safe harbors or simply did not have the lead time to effectively market them.

Further, in Notice 98-52, IRS determined that contributions had to made on behalf of all eligible participants whether or not they worked the normal 1000 hours or were employed on the last day of the plan year.[26] Employer contributions made to a qualified retirement plan are often predicated upon plan participants working 1000 hours of service with the company during the applicable plan year and/or being employed on the last day of the plan year. Top-heavy contributions in the context of a defined contribution plan must be made for all employees who are employed on the last day of the plan year regardless of the number of hours worked.[27] No other type of qualified retirement plan contribution must be made to employees regardless of hours worked or whether the employee is employed on the last day of the plan year. A better alternative would be to require that the 3% contributions be made to either all NHCEs who have worked 1000 hours (the normal employer plan contribution rule) or to those employees who are employed on the last day of the year (the top-heavy minimum defined contribution rule), but not both.[28] When these requirements were coupled with

[26] *Id.*

[27] This particular requirement gives rise to one of the many traps for the unwary in the top-heavy rules. The standard eligibility provision to enter a qualified retirement plan is one year of service in which the employee completes 1000 hours of service (about 20 hours a week) and has attained age 21. Imagine a small business company makes a 6% contribution to its top-heavy retirement plan for the plan participants. As usual, the plan only allocates the contribution to participants who have worked 1000 hours during that plan year. Now if there is a participant who met the eligibility requirements and thereafter worked less than a 1000 hours, this participant would, of course, not be eligible for the 6% contribution, but would still be eligible to receive a 3% defined contribution top-heavy minimum benefit. Because this rule is counter-intuitive and only applies in the top-heavy context, many advisors are not aware of it.

[28] Treasury may have felt constrained to not have this contribution limited by either the 1000 hour requirement or the last day requirement because of the terminology used in the statute. With respect to the 3% nonelective contribution,

the 100% vesting requirement and the safe harbor contributions mandated by the statute, many smaller businesses decided the plan design was too costly.

Moreover, the rules were not clear as to how an existing profit sharing plan could add a safe harbor 401(k) option during the plan year. Instead of promoting the addition of a 401(k) feature to an existing profit sharing plan mid-year, clearly something that the employees would welcome, (and our national retirement policy should welcome in that 401(k) plans clearly encourage employee saving), it appeared that at least for 1999, the only safe course of action was either to have the plan start with the safe harbor at the beginning of the plan year or forego the option for the entire year.[29]

Most importantly, Notice 98-52 made it clear that except for the limited exception available during 1999 for companies with plan years beginning before April 1, 1999, small businesses were going to have to commit to the significant safe harbor contribution 30 days before the new business year even started. For a company that

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the statute requires contributions to be made ". . .on behalf of each employee who is not a highly compensated employee and who is eligible to participate in the arrangement. . . ." I.R.C. §401(k)(12)(C) (CCH 2000). I.R.S. Notice 98-52, expands this language somewhat to require the "safe harbor nonelective contributions on behalf of each NHCE who is an *eligible employee* equal to at least 3 percent of the employee's compensation." I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part V. B.2. All terms used in the Notice have the same meaning as in either Notice 98-1 or the regulations under §401(k) or §401(m). Treas. Reg. §1.401(k)(4)(i) states that "The term 'eligible employee' means an employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year." The authors respectfully submit, however, that even though Treasury's reasoning can certainly be sustained, that an examination of the language used, for instance in the top-heavy rules, in the year of participation for benefit accrual purposes (§411(b)(3)(A), Rev. Rul. 76-250, 1976-2 C.B. 124, and §411(b)(4)(C)), could just as easily be used to justify a 1000 hour limitation or a last day requirement. It runs counter to retirement plan law for employer contributions to be given to employees who do not meet the standards set forth in the plan for receiving employer contributions (*i.e.*, 1000 hours of service and/or last day of the year requirement).

29 Practitioners would query whether the company could keep its existing profit sharing plan, start up a new 401(k) plan during the year and then merge the profit sharing plan into the 401(k) plan the following year. IRS spokesmen at national conferences seemed to indicate that this was conceivable. Of course, this is the type of expensive and unnecessary planning that the authors cannot imagine many small businesses embracing.

was unsure of profits, this commitment was too risky. It appeared small businesses were simply unwilling to commit to this contribution prior to the beginning of the business year.

The required match safe harbor did not appear to be of much interest to small business either, though this was far less of a surprise. The 3% required nonelective safe harbor by and large did satisfy the top-heavy rules. (The 3% nonelective safe harbor had to be made on behalf of all eligible NHCEs whereas the top-heavy contribution had to be made on behalf of all eligible non-key employees.) The required match safe harbor, in contrast, did not satisfy the top-heavy rules.[30] If a company with a top-heavy profit sharing/401(k) plan chose to adopt the required match safe harbor, it was still required to make a 3% top-heavy contribution in addition to the required match contribution. Consequently, this particular option was considered by many small businesses to be too costly. Moreover, Notice 98-52 gave every indication that the match for the safe harbor could not be stopped anytime during the plan year. Thus, as with the 3% employer nonelective safe harbor contribution, a small business was required to commit to a significant contribution prior to the beginning of the year without the benefit of knowing whether the company could indeed afford to make such a contribution.

## § 2.04 WELCOME ACTION BY TREASURY — NOTICE 2000-3

For the reasons discussed above, Notice 98-52 was met by dismay by many small plan advisors. The SBCA repeatedly testified[31]

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[30] The comprehensive pension legislation passed by the House and the Senate would change this so that the required match safe harbor would exempt the plan from the top-heavy rules. This would make this option more attractive to small businesses.

[31] *Increasing Savings for Retirement: Hearings Before the Senate Comm. on Finance*, 106th Cong. (Feb. 22, 1999) (statement of Paula A. Calimafde, on behalf of the SBCA, SBLC, and the Profit Sharing/401(k) Council of America); *Pension Issues Increasing Savings for Retirement: Hearings before House Subcomm. on Oversight, Comm. on Ways and Means*, 106th Cong. (Mar. 23, 1999) (statement of Paula A. Calimafde, on behalf of the SBCA, SBLC, and the Profit Sharing/401(k) Council of America); *Enhancing Retirement Security: Hearings Before House Comm. on Ways and Means*, 106th Cong. (June 15, 1999) (statement of Paula A.Calimafde, on behalf of the SBCA, SBLC, ASPA and the Profit Sharing/401(k) Council of America).

during 1999 that whereas the notice requirement made sense in the context of the required match safe harbor, it made no sense in the required 3% employer nonelective safe harbor. In the context of the required match safe harbor, an employee might very well change his or her behavior and contribute more knowing that a match was going to be made. In the context of the required 3% employer nonelective safe harbor, no similar rationale could be advanced. No employee would change his behavior vis a vis the retirement plan merely because he or she had prior knowledge that a 3% contribution was going to be made for him or her at the end of the plan year. Since the 3% employer nonelective contribution was not dependent upon whether the employee made any 401(k) contributions, advance knowledge could not change the employee's behavior. (Perhaps one could even argue that knowing in advance that an employer contribution was going to be made might convince the employee to save less through his or her own 401(k) contributions.)

The SBCA also explained in its testimony how no qualified retirement plan contributions, other than the 401(k) safe harbor contributions, were required to be made to participants regardless of whether they had met the 1000 hour requirement or were employed on the last day of the plan year. Other major retirement plan associations[32] echoed these concerns as well, and brought up additional concerns. The concept of being able to stop the required match for the safe harbor during the year was discussed and how important this change would be for small businesses. Also explored was the concept of companies matching on a monthly or quarterly basis, but still having to make up any difference at the end of the plan year (the so-called "true up"). Small business believed that if they were matching the employees' 401(k) contributions on an ongoing basis rather than waiting till the end of the year (so that the employees had the advantage of additional tax free growth), employers should not be required at the end of the year to recalculate the matches and add to certain accounts because employees changed the amount they were contributing during the year.

Treasury heard these comments and began a dialogue with members of the IRS, National Office, the Office of Advocacy, U.S.

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[32] In addition to the SBCA, ASPA, the Profit Sharing/401(k) Council and the U.S. Chamber of Commerce were involved in trying to make the 401(k) safe harbors more user friendly.

Small Business Administration and representatives from a number of small business groups.[33]

This entire process was remarkable by Washington standards. Treasury voluntarily met with the small business groups to find out what the small business concerns were with the safe harbors. They listened to the issues and to the solutions advanced by the small business representatives. The small business representatives listened to Treasury's concerns. The meetings were characterized by respect, good will and an attempt on both sides to make the safe harbors workable for small businesses. Notice 2000-3 was the written result of these series of meetings. Unlike Notice 98-52, Notice 2000-3 was met with resounding praise.

First and most importantly, this Notice provided that a small business no longer had to commit the year ahead to its level of safe harbor contributions. In the context of the required match safe harbor, the company could stop its match during the plan year on a prospective basis if the employer gave appropriate notice to the employees.[34]

In the context of the required 3% employer nonelective safe harbor, the company was required to give notice prior to the beginning of the plan year that it *might* make the 3% safe harbor and that if it did, employees would receive notice prior to thirty days before the end of the plan year to that effect.[35] Even though, this seems unwieldy at first, the way this was analyzed by the Treasury, the Office of Advocacy and the small business representatives is as follows: Assume on December 1st, 2000, a small business with a calendar fiscal and plan year sponsors a top-heavy profit sharing/401(k) plan and is considering adopting the 3% employer

[33] Mark Iwry, Don Wellington and Harlan Weller, all from Office of Tax Policy, Treasury, Nancy Marks and Richard Wickersham from National Office of the I.R.S., met several times with Jere Glover, Russ Orban, Ken Simonson, all from Office of Advocacy, the U.S. SBA and representatives from the SBCA, the Small Business Legislative Council ("SBLC"), U.S. Chamber of Commerce and Profit Sharing/401(k) Council, as well as representatives from other groups representing either small business or having expertise in the qualified retirement plan area. Individuals flew in from as far away as California to attend these important meetings.

[34] *See* Technical 401(k) Safe Harbor Provisions, Flexibility *infra* §2.08[5].

[35] *See* Special Rules Allowing Employer to Defer Decision to Use Nonelective Contribution Safe Harbor discussion *infra* §2.10[1].

nonelective safe harbor. The company, however, is not sure it will be able to make the 3% contribution due to the uncertainty of profits during the coming year (2001). In order to keep its options open, it disseminates a notice on December 1st, 2000 to the employees that indicates that the company may adopt the 3% employer nonelective safe harbor in the 2001 year. This notice informs the employees that if the company does, in fact, decide to elect the safe harbor at some point during the year (2001) that it will send out a supplemental notice to the employees to that effect.

Because of a peculiarity in the regulations discussed above,[36] if any key employee of this company makes a 401(k) contribution to the plan, that contribution is deemed to be an employer contribution which triggers the required top-heavy contributions. Thus, this small business must prohibit all key employees from making any 401(k) contributions during the year (or until it is certain it can make the required 3% top-heavy contribution, assuming the key employees want to contribute more than 3% of their compensation). This means that all key employees are precluded from making 401(k) contributions on a payroll deduction basis (which is clearly the most painless way to make 401(k) contributions).

Let's assume it is now December 1st, 2001 and the company has now had the opportunity to determine that it has sufficient profit to make a 3% contribution (100% vested) to all of its non-highly compensated employees so as to satisfy the 3% employer nonelective safe harbor. It now elects the 3% nonelective employer safe harbor and gives the employees a special notice which not only includes the requirements necessary for the supplemental notice[37] in order to properly elect the safe harbor for 2001, but also includes the notice for the employees for 2002 to the effect that the company *may* elect the 3% employer nonelective safe harbor for 2002. Thus, it is only in the first year that two notices are actually required; thereafter one notice no later than 30 days prior to the end of the plan year will suffice for both purposes (notice for succeeding year and notice of the election for the current year).

Employers can decide each year whether to be within the safe harbor or not. Thus, the company has real leeway to decide if it

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[36] Treas. Reg. §1.416-1, Q & A M-20 (as amended in 1992).

[37] *See* Notice Requirements *infra* §2.09.

can make the required safe harbor contribution or not. In short, the single largest objection to the 401(k) 3% employer nonelective contribution has been solved.

Notice 2000-3 also made it clear that a company that had elected the match safe harbor (which does have to be elected thirty days prior to the beginning of the new plan year) can prospectively stop the match. To do this the company must give the appropriate notice and participants time to change their 401(k) cash or deferred elections.[38] The Notice also allowed 401(k) safe harbor plans to match contributions on the basis of compensation for a payroll period, month or quarter as long as the company actually makes the match by the last day of the following quarter. The Notice made it clear that the plan's summary plan description could be cross-referenced in the required notice to employees about the safe harbor rather than having to repeat pages of information. Unfortunately, the employee notice still requires many elements which repeat information that is in the summary plan description. For instance the notice must explain, "how to make cash or deferred elections (including any administrative requirements that apply to such elections) and the periods available under the plan for making such elections."[39] Treasury's intent was that the employees know whom to contact for this information, but absent further clarification by Treasury, employers may need to repeat the summary plan description with respect to these particular items. The Notice also provided another extension of time for giving the requisite employee notice for plans electing the safe harbor methods for the first time in 2000 — plans which have a plan year that begins on or after January 1st, 2000 and on or before June 1st, 2000 have until May 1st, 2000 to provide this notice to the employees.[40]

Finally, the Notice provided how a 401(k) option could be added to an existing profit sharing plan. The Notice makes it clear that a calendar year profit sharing plan may be amended as late as October 1st to add a 401(k) option that uses a 401(k) safe harbor for that year.[41]

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[38] *See* Technical 401(k) Safe Harbor Provisions, Flexibility *infra* §2.08[5].

[39] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #8.

[40] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #9.

[41] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #11.

Every change that was made in Notice 2000-3 was a positive change which, by encouraging the use of 401(k) safe harbors, should encourage small businesses to adopt 401(k) plans. This in turn will help employees of small businesses to save in the easiest and most effective way available today.

## § 2.05 TECHNICAL 401(k) SAFE HARBOR PROVISIONS

### [1] Scope of Nondiscrimination Testing

To ensure that 401(k) plans provide adequate benefits for NHCEs, Congress imposed three nondiscrimination requirements on plans seeking to qualify for tax deferred treatment of contributed funds. These include (1) the Section 401(b) coverage requirements, (2) the Section 401(a)(4) nondiscrimination requirements, and (3) the actual deferral percentage test ("ADP" test)[42] for cash or deferred arrangements ("CODAs"), and the actual contribution percentage test ("ACP" test)[43] for defined contribution plans.

### [2] 401(b) Coverage Tests

The 401(b) coverage tests are designed to ensure that qualified plans extend benefits to a significant percentage of NHCEs as well as highly compensated employees ("HCE").[44] To meet the coverage test, the plan must satisfy one of three tests. To satisfy the first test, the plan must benefit at least 70% of NHCEs.[45] The second test requires that the percentage of NHCEs covered by the plan must be at least 70% of the percentage of HCEs covered by the plan.[46] Under the third test,[47] the plan must either benefit a nondiscriminatory classification of employees,[48] or must provide an average benefit percentage for the group of all NHCEs that is at least 70%

[42] I.R.C. §401(k)(3)(A)(ii) (CCH 2000).

[43] I.R.C. §401(m)(2) (CCH 2000).

[44] *See* discussion *supra* footnote 2.

[45] I.R.C. §410(b)(1)(A) (CCH 2000).

[46] I.R.C. §410(b)(1)(B) (CCH 2000).

[47] I.R.C. §410(b)(2) (CCH 2000).

[48] I.R.C. §410(b)(2)(A)(i) (CCH 2000); Treas. Reg. §1.410(b)-4 (as amended in 1991).

of the average benefit percentage provided for the group of all HCEs.[49]

## [3] Section 401(a)(4) Nondiscrimination Requirements

The nondiscrimination requirements of IRC Section 401(a)(4) also ensure that contributions and benefits provided under a plan do not discriminate in favor of HCEs. There are two safe harbors for satisfying these nondiscrimination requirements. A plan that allocates contributions using the same percentage of compensation or same dollar amount for each employee satisfies the "uniform formula" safe harbor. A plan that allocates contributions based on "points" credited to a participant can satisfy the "age or service weighting formula" safe harbor. Points must be provided on a uniform basis for compensation, age or years of service. If the safe harbors are not met, the plan must use cross testing[50] to satisfy the Section 401(a)(4) nondiscrimination requirements.

## [4] The ADP and ACP Tests

Of the three nondiscrimination tests, the ADP test[51] and ACP test[52] are often the most complex and costly to administer. Unlike the other nondiscrimination tests, which can be satisfied through plan design, the ADP and ACP tests (at least prior to the 401(k) safe harbors) require annual testing. Moreover, the amounts which NHCEs actually elect to defer effectively limit the amounts which HCEs may elect to defer, even if the HCEs might otherwise choose greater deferrals permitted by the plan or the law. The choices made by NHCEs as to the amount they wish to contribute to the 401(k), therefore, can restrict the choices available to HCEs. If a plan does

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[49] I.R.C. §410(b)(2)(A)(iii) (CCH 2000); Treas. Reg. §1.410(b)-5 (as amended in 1993). These tests are generally referred to as the average benefit percentage test. A benefit percentage reflects the employer-provided contribution or benefit of an employee under all qualified plans maintained by the employer as a percentage of the employee's IRC §414(s) compensation.

[50] Cross testing allows defined contribution plans to be tested for nondiscrimination in terms of benefits, rather than contributions. Allocations are converted into equivalent accrual rates to satisfy the Defined Benefit General Test under Treas. Reg. §1.401(a)(4)-8(c)(2) (as amended in 1993). The cross testing rules are beyond the scope of this chapter.

[51] I.R.C. §401(k)(3)(A)(ii) (CCH 2000).

[52] I.R.C. §401(m)(2)(A) (CCH 2000).

not satisfy the ADP or ACP tests in any given year, either the plan must return "excess" deferrals made by HCEs or increase contributions made by the employer on behalf of NHCEs.

### [5] Technical Description of the ADP Test

The actual deferral percentage for an individual participant compares (a) the amount of certain employer contributions (401(k) contributions and employer contributions that are immediately vested and subject to 401(k) restrictions) paid to a trust in a particular year on behalf of the participant to (b) the participant's compensation for that year. The ADP for each participant in the non-HCE group is then averaged, as is the ADP for each participant in the HCE group. A plan satisfies the ADP test in one of two ways. Under the "general" test the ADP for the HCE group may not be more than 1.25 times the ADP for that of the NHCE group. Under the "alternative" limitation test, the ADP for HCEs may not exceed the ADP for NHCEs by more than 2 percentage points *and* may not be more than double the ADP for NHCEs. Thus, to the extent that eligible NHCEs do not make any elective deferrals at all, or make elective deferrals of far lower percentages of compensation than that of the HCEs, NHCEs limit the permitted rate of elective deferrals of HCEs.

### [6] Technical Description of the ACP Test

The ACP test imposes similar limitations on matching contributions and employee after-tax contributions. The actual contribution percentage compares the sum of the matching contributions and employee after-tax contributions paid under a plan on behalf of a participant during a plan year with the participant's compensation. Again, under the "general" ACP test, the ACP for the HCE group may not be more than 1.25 times the ACP for NHCE group. Under the "alternative" limitation test, the ACP for HCEs may not be more than 2 percentage points greater than the ACP for NHCEs *and* may not be more than double the ACP for NCHEs.

### [7] Multiple Use Testing

The alternative limitation tests are used when NHCEs contribute at a low average rate. Under the "multiple use" limitation, however, the alternative tests may be used to satisfy the nondiscrimination

tests for either elective contributions under Section 401(k)(3) or for matching and employee after-tax contributions under 401(m), but not for both. Using the alternative limitation to satisfy both the ADP test and the ACP test requirements would be a "multiple use" of the alternative limitation. A detailed discussion of multiple use testing and certain proposals by the IRS to simplify the process is beyond the scope of this chapter. Suffice it to say that multiple use testing is both highly complex[53] and unnecessarily complicated.

## § 2.06 THE ADP TEST AND ACP TEST SAFE HARBORS

### [1] Purpose of the ADP and ACP Safe Harbors

As previously noted, the ADP and ACP tests can be both costly and burdensome. To encourage increased sponsorship of 401(k) plans and reduce their administrative costs, Congress created statutory design-based safe harbors for satisfying the ADP and ACP tests.[54] By designing a 401(k) plan to qualify under these safe harbors, the employer could eliminate[55] the need for expensive record keeping and annual testing.[56] In addition, the participation levels of HCEs could be freed from the behavior of the NHCEs.

### [2] The Safe Harbors

There are two types of "safe harbor" for both the ADP and the ACP tests — a nonelective 3% employer contribution and a

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[53] Even the IRS, in requesting recommendations concerning multiple use testing in Notice 2000-3, indicated that "the approach taken under existing regulations in implementing the limitation on multiple use may be unnecessarily complicated." I.R.S. Notice 2000-3, 2000-4 I.R.B. 413.

[54] Sections 1433(a) and (b) of the Small Business Job Protection Act of 1996 added Sections 401(k)(12) and 401(m)(11) to the Internal Revenue Code, effective for plan years beginning after December 31, 1998.

[55] If the plan permits employee after-tax contributions, ACP testing is still required, but record keeping and annual testing for the ADP test will be eliminated.

[56] Section 1433(c) of the Small Business Job Protection Act of 1996 amended I.R.C. §401(k)(3)(A), effective for plan years beginning after December 31, 1996, to provide for the use of prior year data in determining the ADP and ACP of NHCEs. Current year data, however, is still required for HCEs. The rules governing the election to use current or prior year data, and the ability to switch from one approach to the other is beyond the scope of this article. IRS, however, treats a plan that relies on a safe harbor method to satisfy the ADP or ACP test as using current year data. I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part VIII.E.

matching contribution. The matching contribution safe harbor can either be the basic statutory matching safe harbor or an enhanced matching design which satisfies certain statutory requirements.

### [3] The Nonelective Contribution Safe Harbor

The "profit sharing" safe harbor, referred to as the "nonelective contribution method," requires a minimum 3% nonelective employer contribution.[57] Under this safe harbor, the employer contributes to the plan at least 3% of the compensation of each NHCE who is eligible to make pre-tax contributions to the plan, regardless of whether the employee actually elects to defer any compensation. This safe harbor may also be used to satisfy the top-heavy minimum requirement, and may be used in non-discrimination testing, but may not be used for permitted disparity testing under IRC Section 401(l).[58]

### [4] Matching Contribution Safe Harbors: Basic Match Formula

There are two types of matching contribution safe harbors. Under the basic matching formula,[59] the employer must make a matching contribution for each eligible NHCE equal to (a) 100% of the NHCE's elective contributions up to 3% of compensation and (b) 50% of the NHCE's elective contributions for the next 2% of compensation. Thus, if the NHCE employee contributes 5% of his or her compensation, the employer must match with a contribution equal to 4% of the employee's compensation.

### [5] Enhanced Matching Formula

Under the enhanced matching formula,[60] the employer may select any matching rate which satisfies the following criteria: (a) the total rate of match at each and every level of elective contributions must be at least as high as that under the basic matching formula;[61] (b) the matching rate cannot increase with increases in

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[57] I.R.C. §401(k)(12)(C) and (m)(11)(i) (CCH 2000).

[58] I.R.C. §401(k)(12)(E)(ii) (CCH 2000); I.R.S. Notice 98-52, 1998-46 I.R.B. 16.

[59] I.R.C. §401(k)(12)(B)(i) and (m)(11)(i) (CCH 2000).

[60] I.R.C. §401(k)(12)(B)(iii) and (m)(11)(i) (CCH 2000).

[61] I.R.S. Notice 98-52, 1998-46 I.R.B. 16.

the rate of elective contributions; and (c) the rate of match for any HCE cannot exceed the rate of match for any NHCE at the same level of elective contribution.

For example, a plan that matches 100% of an employee's elective deferrals up to 4% of compensation will qualify as an enhanced matching formula.[62] For elective deferrals up to 3% of compensation, the rate of match under this enhanced formula equals that under the basic matching formula. For elective deferrals greater than 3% but less than 5% of compensation, the rate of match exceeds that under the basic matching formula, and for elective deferrals of 5% of compensation, the rate of match equals that provided under the basic match formula.

A plan that matches 125% of employee elective deferrals up to the first 3% of employee deferrals and matches 25% of elective deferrals from 3–4% of compensation, with no additional match thereafter, also satisfies the criteria. For elective deferrals up to 5% of compensation, the enhanced matching formula creates matches which exceed those of the basic match formula. For elective deferrals of 5% of compensation, the match under both formulae is 4% of compensation.

A plan which provides the basic matching formula for Division A employees and a 100% match for elective deferrals up to 5% of compensation for Division B employees does not satisfy the safe harbor. The matches provided to Division B HCEs who elect to defer amounts in excess of 3% of compensation exceed the matches available to Division A NHCE's electing to defer the same percent of compensation.

Similarly a plan that matches 100% of elective deferrals up to 2% of compensation but only 25% of additional elective deferrals up to 5% of compensation does not satisfy the enhanced formula matching contribution safe harbor. The rate of match for elective deferrals in excess of 2% of compensation is less than the rate of match under the basic formula.

Finally, a plan that matches 100% of elective deferrals up to 3% of compensation and 150% of elective deferrals of the next 2% of

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[62] An excellent outline on Section 401(k) safe harbors, Merl, Safe Harbor 401(k) Plans, which was written prior to I.R.S. Notice 2000-3 and presented by Elinor R. Merl at the 1999 ASPA Conference (October 25, 1999), includes several of the examples which are discussed in the text.

compensation does not qualify. The rate of match increases as the rate of deferral increases.

### [6] Discretionary Matching Contributions

Only matching contributions which are required to be made by the plan document will be taken into account in determining whether a plan satisfies an ADP matching contribution safe harbor. Discretionary matching contributions may not be taken into account. However, a plan which otherwise satisfies a safe harbor by requiring certain minimum employer matching contributions will not fail as an ADP safe harbor merely because additional discretionary employer matching contributions are allowed and made.[63]

### [7] Special Rules Applicable to the ACP Safe Harbors

The ACP safe harbor includes a nonelective contribution method, basic match formula and enhanced match formula which are similar to those that apply to the ADP safe harbor. The ACP safe harbor imposes two additional requirements, the first imposed by statute and the second by regulation. First, the employer may not match employee contributions or elective deferrals in excess of 6% of compensation.[64] (The plan, however, may permit the employee to defer or contribute more than 6% of compensation, assuming all other contribution limitations are satisfied, as long as the employer does not match these additional deferrals or after-tax employee contributions.) Second, for plan years beginning after January 1, 2000, the plan may not provide for employer discretionary matching contributions that in the aggregate could exceed an amount equal to 4% of compensation.[65]

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[63] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part VI.B.4.

[64] I.R.C. §401(m)(11)(B)(i) (CCH 2000).

[65] I.R.S. Notice 98-52, 1998-46 I.R.B. 16. The 6% and 4% requirements can be illustrated by the following examples. Assume that a plan satisfies the ADP safe harbor using a 3% nonelective contribution. The plan also offers a 50% match on up to 6% of employee pretax deferrals. This plan will satisfy the ACP safe harbor because it does not apply to more than 6% of employee deferrals and does not produce discretionary matching contributions which in the aggregate exceed 4% of compensation. If, in addition, the plan offers a 50% match on up to 6% of an employee's after tax contributions, the plan would no longer satisfy the ACP safe harbor for three reasons. First, the ACP safe harbor cannot be used with respect to employee after-tax contributions. Second, as explained in the analysis of this

## § 2.07 RELATIONSHIP BETWEEN THE ADP TEST AND ACP TEST SAFE HARBORS

The safe harbor plan design may be used to satisfy only the ADP test or both the ADP and ACP tests. A plan cannot satisfy the ACP safe harbor, however, without also satisfying the ADP safe harbor.[66]

### [1] Plan Can Satisfy ADP Safe Harbor Without Satisfying ACP Safe Harbor

A plan that satisfies the ADP safe harbor through a nonelective contribution or a basic match will automatically satisfy the ACP safe harbor as well as long as the plan provides no other matching contributions.[67] A plan which satisfies the ADP safe harbor using an enhanced matching formula, however, will not necessarily satisfy the ACP safe harbor. This would arise, for example, if a plan matches employee after-tax contributions.[68] Employee after-tax contributions must be tested annually under the traditional ACP test; they are not covered by the ACP safe harbor.[69]

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example in I.R.S. Notice 98-52, VI.D., Example 3, the plan would be providing matching contributions on elective contributions and after-tax employee contributions that in the aggregate equal 12% of compensation. Third, the matches, in the aggregate, could exceed 4% of compensation.

[66] In order for a defined contribution plan to satisfy the ACP test safe harbor, each NHCE eligible to receive an allocation of matching contributions under the plan must also be an eligible employee under a CODA that satisfies the ADP test safe harbor. IRS Notice 98-52, 1998-46 I.R.B. 16.

[67] If the plan does provide additional matching contributions for employee after-tax contributions, these, at a minimum, must be separately tested annually under traditional ACP testing. As pointed out in the example, *supra* footnote 65, these additional matching contributions may violate any of a number of separate requirements.

[68] *See* example analyzed *supra* footnote 65.

[69] For a discussion of the special rules that apply when testing employee after-tax contributions under a plan which satisfies the ADP safe harbor. *See* Special ACP Testing Requirements, Special Testing Rules Applied if Plan Satisfies ADP Safe Harbor but Traditional ACP Testing is Required *infra* at § 2.07[1].

### [2] Satisfying the ACP Safe Harbor in a Plan Allowing Matching Contributions on Both Elective Deferrals and Employee After-Tax Contributions

A plan that provides matching contributions on both elective deferrals and employee after-tax contributions can still satisfy the ADP and ACP safe harbor requirements with respect to employee elective deferrals if certain requirements are met. In general, the concern in any plan which allows both elective deferrals and employee after-tax contributions is whether the plan, taken as a whole, satisfies the requirement that at any rate of elective contributions (or employee after-tax contributions), the rate of matching contributions that applies with respect to HCEs is not greater than the rate of matching contributions applicable to NCHEs with the same rate of elective contributions (or employee-tax contributions).[70] To satisfy this requirement, the plan must provide either that (i) matching contributions provided on an employee's elective contributions are not affected by the amount of an employee's after-tax employee contributions, or that (ii) matching contributions will be made with respect to the sum of elective contributions and employee after-tax contributions under the same terms as matching contributions are made with respect to elective contributions alone. These requirements in effect permit a plan which satisfies these conditions to provide matching contributions on an employee's aggregate employee and elective contributions. An example will illustrate how these requirements work. Assume that a plan provides a required matching contribution equal to 100% of the sum of each eligible employee's elective contributions and employee after-tax contributions up to 4% of compensation. An eligible employee first makes employee after-tax contributions equal to 4% of compensation (which are matched) and then makes elective contributions of 2% of compensation (which are not matched). Had the employee first made the elective contributions and then made the employee contributions, and had the total match been the same (that is, the elective contributions were fully matched and the first 2% of employee after-tax contributions were matched), then the plan would still satisfy the safe harbor so long as all other safe harbor

[70] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, V.B.1.b and VI.B.3.(iii). The references to employee after-tax contributions arise only with respect to the ACP safe harbor.

requirements were met.[71] Alternatively, the plan could satisfy the safe harbor requirements if it provided that, regardless of the level of employee after-tax contributions, the plan would match at 100% the 4% elective contributions.[72]

## § 2.08 TECHNICAL REQUIREMENTS APPLICABLE TO ADP TEST AND ACP TEST SAFE HARBORS

### [1] Contributions Must be Nonforfeitable and Subject to Withdrawal Restrictions

Both the ADP test safe harbor and the ACP test safe harbor require that all matching contributions and nonelective contributions used to satisfy the safe harbor be nonforfeitable and be subject to the withdrawal restrictions of Section 401(k)(2)(B). Thus, to the extent that a match for the ACP safe harbor is *not* used to satisfy the ADP safe harbor (*e.g.*, ADP safe harbor is met by making the nonelective contribution or the match is a discretionary match which does not exceed 4% of compensation), it need not be fully vested or subject to the 401(k) withdrawal restrictions. Minimum matching contributions and minimum nonelective contributions used to satisfy the safe harbors must be fully vested and may not be distributable earlier than the employee's attainment of age 59 1/2,[73] separation from service, death or disability, termination of the plan without creation of a successor plan, disposition of a subsidiary or hardship.[74]

### [2] Permissible Restrictions on Elective Contributions

Elective contributions by NHCEs may be restricted only in four ways. First, the plan may limit the frequency and duration of the period in which eligible employees may make or change their cash or deferred elections. Eligible employees must have at least 30 days after receiving the safe harbor employee notice in which to make or change an election.[75]

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[71] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413.

[72] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413.

[73] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part IV.H.

[74] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part IV. H.

[75] I.R.S. Notice 98-52, 1998-46 I.R.B. 16.

Second, the plan may limit the amount of elective contributions so long as each eligible employee is permitted to defer sufficient compensation to receive the maximum amount of matching contributions allowed under the plan[76] and is also permitted to defer lesser amounts. The plan may require that employees make elective contributions either in whole percentages of pay or in whole dollar amounts.[77]

Third, the plan may limit the types of compensation which may be deferred as long as each eligible NHCE is permitted to make elective contributions under a definition of "compensation" which is "reasonable"[78] although not necessarily "nondiscriminatory."[79] This requirement in effect means that the plan must use a Section 414(s) definition of "compensation."[80] The compensation on which safe harbor percentages are applied may be limited to compensation earned during the portion of the plan year or calendar year in which the employee is eligible under the plan as long as this limitation is applied uniformly to all eligible employees under the plan for the plan year.[81] In addition, applicable compensation must be limited in order to comply with Section 401(a)(17).[82]

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[76] For example, assume that a plan provides a required matching contribution equal to 100 percent of each eligible employee's elective contributions up to 4% of "compensation" (as defined in I.R.C. §415(c)(3)). However, elective contributions are limited to 15% of the employee's "basic compensation" and "basic compensation" is defined as certain compensation excluding overtime pay. (This is a "reasonable" definition within the meaning of Treas. Reg. §1.414(s)-1(d)(2)). The limitation on the amount of pretax contributions and on the type of compensation that may be deferred will be acceptable as long as within these restrictions, each eligible NHCE may still make elective contributions equal to at least 4% of his "compensation" as defined in I.R.C. §415(c)(3). In other words, notwithstanding the restrictive definition of "compensation" used for determining compensation from which elective contributions may be made, the employee may still make an amount of elective contributions sufficient to receive the maximum amount of matching contributions available under the plan.

[77] I.R.S. Notice 2000-3, 2000-4 I.R.B.413, at Q&A #3.

[78] The definition of "compensation" used in a plan must be "reasonable" within the meaning of Treas. Reg. §1.414(s)-1(d)(2).

[79] The definition of "compensation" used in a plan need not satisfy the nondiscrimination requirement of Treas. Reg. §1.414(s)-1(d)(3).

[80] I.R.S. Notice 98-52, 1998-46 I.R.B. 16.

[81] Treas. Reg. §1.401(k)-1(g)(2); I.R.S. Notice 98-52, 1998-46 I.R.B. 16.

[82] I.R.C. §401(a)(17) limits the annual compensation which may be taken into account for any eligible employee under the plan to $150,000 annually, adjusted for inflation. In 2000, the annual compensation limit is $170,000.

Fourth, the plan may limit the amount of elective contributions in order to comply with other requirements of the Internal Revenue Code,[83] or if an employee's ability to make elective contributions has been suspended for 12 months, or limited as a result of a hardship distribution.[84]

### [3] Conditions of Eligibility Distinguished

Contributions may not be subject to a "year of service" requirement,[85] nor may they be conditioned upon the employee's being employed on the last day of the plan year. The plan, however, can require as *conditions of eligibility* to participate in the plan that the employee attain at least age 21 and that the employee satisfy a "year of service" requirement.[86] Additional employer profit sharing contributions under the plan may be subject to a vesting schedule, to a 1,000 hour of service requirement and to a requirement that the employee be employed on the last day of the plan year. Vesting and withdrawal restrictions may also be imposed on matching contributions not needed to satisfy the safe harbor test.

### [4] Length of Plan Year

While a plan year must generally be 12 months long,[87] there are

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[83] *See e.g.* I.R.C. §402(g) and 415.

[84] I.R.S. Notice 98-52, 1998-46 I.R.B. 16. Note that the plan can also suspend additional employee after-tax contributions for a period of up to 12 months after an employee withdraws employee contributions from the plan. IRS Notice 2000-3, 2000-4 I.R.B. at Q&A #4.

[85] A "year of service" requirement would be a requirement that the employee work, for example, at least 1,000 hours of service in a 12 month period.

[86] For example, if an employer elects under I.R.C. §410(b)(4) to treat employees who have not yet attained age 21 or completed a year of service separately for Section 410 coverage purposes, and if the plan is accordingly treated as two separate plans (with one plan benefitting only employees who do not satisfy these requirements), then either plan can satisfy the ADP test safe harbor independently of the other. In essence, the employees who do not satisfy either the age 21 or year of service requirement are treated as not being eligible employees so long as the employer has elected to treat them separately for coverage purposes under Section 410(b). However, the plan must then specifically provide that elective contributions (and, if applicable, matching contributions) on behalf of the employees who are not "eligible" employees, will satisfy the traditional ADP test (and, if applicable, the traditional ACP test.). I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part IX.B.1; I.R.S. Notice 2000-3, 2000-4 I.R.B. 413., at Q&A #10.

[87] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part X.

many exceptions to this rule. The first year of a newly established plan (not a successor plan) may be as little as 3 months long. In addition, a CODA may be added as much as 9 months after the beginning of a plan year to an existing profit-sharing, stock bonus or pre-ERISA money purchase pension plan that is not a "successor" plan.[88] In this case, the safe harbor requirements only need be satisfied from the effective date of the CODA to the end of the plan year. Similar rules apply if matching contributions are added for the first time to an existing defined contribution plan at the same time as the CODA is adopted. Even the 3 month minimum is waived for new employers if the new employer sets up the plan as soon as is administratively possible.

### [5] Flexibility

IRS representatives have indicated that a safe harbor plan cannot have a short year other than in the initial year. Thus, it appears that the plan itself cannot be terminated through merger and cannot change the plan A plan which adopts a 401(k) ADP or ACP safe harbor, however, is not necessarily stuck with that decision. The decision to rely on a safe harbor may be made on a year by year basis.[89] Moreover, an employer may wait until 3 months before the end of a plan year to decide to rely on the nonelective contribution (3%) safe harbor as long as the employer properly notifies employees of this possibility prior to the beginning of the plan year.[90]

A plan that relies on a matching contribution safe harbor even has considerable flexibility within the plan year to suspend matching contributions. The plan may be amended during the year in order to suspend *future* elective or employee after-tax contributions within

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[88] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #11.

[89] Note that a plan that uses a safe harbor method to satisfy the ADP or ACP test for a plan year will be treated as using the current year testing method for that year. Accordingly, in changing from a safe harbor method to a traditional ADP or ACP test method from one year to the next, the plan will be subject to the rules relating to changes from current year to prior year testing. These rules are beyond the scope of this paper. They are set forth, however, in I.R.S. Notice 98-1, 1998-44 I.R.B. 11, at Part VII.

[90] *See* Amendments to Plan Documents, Special Rules Allowing Employer to Defer Decision to Use Nonelective Contribution Safe Harbor *infra* at § 2.10[1].

that plan year.[91] To switch prospectively within a plan year from the safe-harbor to current year ADP or ACP testing, however, the plan must be amended to indicate that the plan will reduce or eliminate matching contributions and will satisfy the ADP test (and, if applicable, the ACP test) for the entire plan year using the current year ADP and ACP testing method. The plan must also be amended to provide that eligible employees will be given a supplemental notice (i) indicating the consequences of the plan amendment and the effective date of any reduction or termination of matching contributions and (ii) informing eligible employees that they will have a reasonable opportunity (and reasonable amount of time) to change their cash or deferred and employee after-tax elections. The notice must, in fact, be given and eligible employees must, in fact, be given a reasonable opportunity (and reasonable amount of time) to change their elections. The matching contributions may be reduced or eliminated no earlier than 30 days after the employer provides this notice or the date the plan amendment is adopted, whichever is later. Finally, until the change is effective, the plan must satisfy all safe harbor requirements.

### [6] Timing of Making Matching Contributions

Matching contributions for elective deferrals and employee mandatory or voluntary after-tax contributions under a 401(k) safe harbor plan may be made either at the end of the plan year or, if the plan provides, on a more frequent basis (*e.g.*, payroll-by-payroll or with respect to all payrolls ending within a particular month or with respect to all payrolls ending within a plan-year quarter). If the matching contributions are made on an annual basis, then the matching contributions must be made to the plan no later than 12 months after the close of the plan year. They must be allocated as of a date within the plan year and may not be conditioned on events that take place after the year end. These general requirements are the same as those applicable to the current year testing method for ADP and ACP testing.[92] If the plan uses the payroll period method, matching contributions must be contributed to the plan by the last day of the plan year quarter following the plan year quarter in which

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[91] I.R.S. Notice 2000-3, 2000-4, I.R.B. 413, at Q&A #6.

[92] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part VIII.A.

the elective deferral or employee after-tax contribution is made.[93] For example, in a calendar year plan, matching contributions made during the calendar quarter starting July 1, 2000 must be made by December 31, 2000.[94]

Allowing employers to make safe harbor matching contributions using the payroll period method eliminates the need to "true-up" or rectify at the end of each plan year any discrepancies between the amount of matching contributions that are required based upon elective deferrals and employee after-tax contributions made within a particular payroll period and those that would be required to satisfy a safe harbor in light of an employee's total compensation and total deferrals or contributions for the plan year. Thus, if the employer makes the contributions required based on payroll by payroll elective deferrals and employee after-tax contributions, the employer will not be required to make additional contributions at the end of the plan year to take into account the employee's total compensation for the plan year.

### [7] Multiple CODAs and Multiple Plans

Safe harbor contributions may be made to the plan that contains the CODA or to another defined contribution plan that satisfies Section 401(a) or Section 403(a).[95] Both plans must have the same plan year, and each employee who is eligible under the CODA must be eligible under the same conditions under the other defined contribution plan. The plans, however, do not need to be capable of being aggregated under IRC Section 410(b).[96] Safe harbor matching or nonelective contributions used to satisfy the safe harbor contribution requirement of one plan may not be used to satisfy those same requirements with respect to a second plan. Finally, restrictions which generally apply to 401(k) contributions (for example, restrictions on withdrawals) must also apply to contributions made to the second plan. This may require amending the second plan.

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[93] This requirement applies to matching contributions made during a plan year quarter beginning after May 1, 2000.

[94] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #2.

[95] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part IX.A.

[96] Because the two plans do not need to be capable of being aggregated, a contribution to an ESOP may be used to satisfy the safe harbor test even if the CODA is not part of the ESOP.

### [8] Aggregation and Disagrgregation

The rules that apply for aggregating and disaggregating plans under traditional ADP and ACP testing also apply to ADP and ACP safe harbor testing. All CODAs included in a plan are treated as a single CODA that must satisfy the ADP safe harbor contribution and notice requirements. Two plans which are treated as a single plan under the permissive aggregation rules must also be treated as a single plan for purposes of the safe harbor rules. Conversely, if two parts of a single plan may be disaggregated, then either may satisfy the ADP safe harbor even if the other does not. For example, a CODA covering employees subject to collective bargaining and one covering other employees may be treated as two separate plans, and either plan may satisfy the ADP safe harbor even if the other plan does not. Also, if an employer makes a Section 410(b) election to treat a portion of a plan covering employees who have not yet attained age 21 or completed a year of service separately from the portion of the plan covering employees who do meet these requirements, then the ADP safe harbor test need not be satisfied by both plans in order for one of the plans to take advantage of the safe harbor rules.[97]

Elective and matching contributions made on behalf of a HCE who is eligible to participate in more than one plan of the same employer must generally be aggregated and treated as made under *each* of the plans, even if only one of the plans is intended to satisfy an ADP or ACP safe harbor.[98] This requirement can be particularly troublesome. If the matching contribution formula for the plan which does not rely on safe harbor testing provides greater matching contributions than the matching formula of the plan which does rely on safe harbor testing, the safe harbor requirements may not be satisfied; viewed together, the plans may afford the HCE a greater rate of matching contributions than are afforded NHCEs. Safe harbor requirements could even be violated if the HCE is merely transferred from a plan covering one group of employees to a plan covering a different group of employees.[99]

[97] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part IX.B.

[98] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part IX.B.2.

[99] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part IX.B.2.

## § 2.09 NOTICE REQUIREMENTS

Within a reasonable period[100] prior to the beginning of the plan year, each employee must be given notice[101] that the plan intends to rely upon a safe harbor formula. The notice must inform the employee of his or her rights and obligations under the plan and must be written in a manner that the average eligible employee can understand.[102] The notice must describe the safe harbor matching or nonelective contribution formula that will be used under the plan, including the levels of any matching contributions. The notice must also indicate whether any other contributions may be made under the plan (for example, discretionary matching contributions) and the conditions under which these contributions will be made. If contributions will be made to a plan other than the one containing the CODA, the notice must identify the other plan. The notice must also indicate the type and amount of compensation that may be deferred under the plan, how to make the cash or deferred election (including any administrative requirements that apply to the election), the periods available under the plan for making the election, and any withdrawal and vesting provisions. Much of this information may be provided by cross-referencing the relevant portions of the summary plan description in the notice.[103]

[100] The reasonable period is generally deemed satisfied if notice is given to each eligible employee at least 30 days and no more than 90 days before the beginning of each plan year. For a newly eligible employee, the notice must be given no more than 90 days prior to the eligibility date but may be given as late as the eligibility date. Thus, for a new employee who is immediately eligible under the plan, notice may be given within 90 days prior to or on the first day of employment.

[101] The IRS is planning to issue additional guidance concerning using electronic media to provide the required notice to eligible employees. Until IRS provides the additional guidance, the notice may be given electronically as long as the notice is reasonably accessible to the employee, the electronic medium is designed to provide a notice which is no less readily understandable than a paper notice, and the employee is advised that he or she may request a written notice at no extra charge. I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #7.

[102] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Parts V.C. and VI.

[103] Information regarding other contributions which may be made under the plan, the plan to which safe harbor contributions will be made, the type and amount of compensation that may be deferred, and withdrawal and vesting may be made by cross-referencing the relevant portions of a summary plan description. I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #8.

Plans adopting 401(k) safe harbor methods for the first time in 2000 have until May 1, 2000, to provide the safe harbor notice to employees.[104] This transition rule regarding the timing of notice applies both to newly established 401(k) plans and to pre-existing plans adopting the safe harbor method for the first time in the year 2000.

## § 2.10 AMENDMENTS TO PLAN DOCUMENTS

Using the safe harbor methods requires some changes to plan documents. Prior to the beginning of the plan year, the plan document generally must indicate that the plan intends to meet the ADP and, if applicable, ACP test and the method that will be used. The plan must also indicate whether safe harbor contributions will be made to another plan and, if so, must identify the other plan. If contributions will be made to another plan, that other plan also must, prior to the beginning of the plan year, adopt provisions specifying that safe harbor contributions will be made and providing the necessary withdrawal and vesting restrictions.[105]

### [1] Special Rules Allowing Employer to Defer Decision to Use Nonelective Contribution Safe Harbor

One perceived drawback to using design based methods to satisfy the ADP and ACP test requirements is that these safe harbors require the employer to commit, prior to the beginning of the plan year, to make certain contributions to the plan.[106] An employer, particularly a small business, might not be able to commit to a 3% contribution until it has the actual financial data in hand so that it could then determine what it could afford to make to the plan in a given year. Clearly, an employer's decision to satisfy the ADP and ACP tests in a plan year by relying on the matching contribution safe harbor could affect the amount of elective deferrals made by the employees. Accordingly, employers that do plan to rely on the matching contribution safe harbor must notify employees of this decision prior to the beginning of the plan year. A plan that adopts a 3% nonelective contribution method for satisfying the safe harbor,

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[104] I.R.S. Notice 2000-3, 2000-3 I.R.B. 297, at Q&A #9.

[105] *See* I.R.S. Notice 98-52, 1998-46 I.R.B. 16.

[106] *See* Welcome Action By Treasury — Notice 2000-3, 200-4 I.R.B. 413.

however, does not affect the level of employee elective deferrals. In other words, if an employer notifies employees prior to the beginning of the plan year that the plan intends to satisfy the ADP and ACP tests, a subsequent decision by the employer to satisfy these requirements using the 3% nonelective contribution safe harbor should not impact on employee behavior. Thus, the employer's decision to rely on the nonelective contribution safe harbor may be deferred until late in a plan year without adversely affecting employees.

To afford employers flexibility to defer until December 1 of a calendar year plan the decision to adopt the nonelective contribution safe harbor, IRS Notice 2000-3 provides that if a plan provides prior to the beginning of the plan year that it *may* satisfy the current year ADP (and, if applicable, ACP) testing method for a plan year by using the 3% safe harbor, then the plan may be amended as late as 30 days prior to the last day of the plan year to indicate that the plan *will* use the 3% nonelective contribution method to satisfy the ADP (and if applicable, ACP) test and that the necessary contribution will be made.[107] Thus, the notice provided to employees prior to the beginning of the plan year need only indicate that the plan *may* be amended during the plan year to provide that the employer will make a safe harbor nonelective contribution of at least 3 percent to the plan and that if the plan is in fact amended, the employer will provide eligible employees supplemental notice at least 30 days prior to the last day of the plan year both of the amendment and the 3% nonelective contribution. This subsequent notice may also include the requisite safe harbor notice for the next plan year. There is no limit to the number of consecutive years in which the employer can delay deciding whether or not to use the 3% nonelective contribution safe harbor and no requirement that the safe harbor continue to be used in subsequent plan years.[108]

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[107] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #1.

[108] To simplify these requirements, the IRS intends to provide a pre-approved means of adopting the 401(k) safe harbor nonelective contribution method under the IRS' master and prototype plan program.

## § 2.11 SPECIAL ACP TESTING REQUIREMENTS

### [1] Special Testing Rules Applied if Plan Satisfies ADP Safe Harbor but Traditional ACP Testing is Required

As previously noted, a plan can satisfy the ADP test safe harbor without necessarily satisfying the ACP safe harbor. This may result because the matching contribution portion of the plan does not satisfy the ACP test safe harbor. In this case, the matching contributions must satisfy the traditional ACP test. This may also result if the plan allows employee after-tax contributions. These contributions cannot satisfy the ACP safe harbor and must be tested under traditional ACP testing. Under either circumstance, because the plan satisfies the ADP safe harbor, special rules apply to the ACP testing.

First, the plan needs to satisfy the ACP test using a current year testing method.

Second, in applying the ACP test, the employer may elect to disregard certain other contributions to the plan. For example, if a plan satisfies the ACP test safe harbor with respect to employer matching contributions, and traditional ACP testing is required only for employee after-tax contributions, then the employer may elect to disregard the matching contributions when applying the traditional ACP test to employee after-tax contributions. However, if the employer has satisfied the ADP safe harbor, but does not satisfy the ACP safe harbor, then the employer may disregard matching contributions that do not exceed 4% of each employee's compensation when applying the traditional ACP test to additional employer matching contributions.

Special rules also apply regarding whether certain contributions may be taken into account with respect to one test rather than the other.[109] For example, qualified nonelective contributions which are not needed to satisfy the ADP safe harbor requirements may be treated as matching contributions when applying the ACP test.[110] However, matching contributions may not be excluded from the ACP test by being treated under Section 401(k)(3)(D) as elective

[109] These rules are extraordinarily complex and a full treatment of the regulations is beyond the scope of this article. *See generally* Treas. Reg. §§1.401(k)-1(b)(5) and 1.401(m)-1(b)(5).

[110] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at VIII.F.3.

contributions (elective deferrals) to a CODA that satisfies the ADP safe harbor.[111] Those elective contributions must be taken into account in applying the ACP test. Finally, elective contributions under a CODA that satisfies the ADP test safe harbor may not be treated as matching contributions for purposes of the ACP test.

### [2] Multiple Use Restrictions as Applied to Safe Harbors

Multiple use restrictions do not apply to a CODA that satisfies the ADP safe harbor. Nor do they apply to a defined contribution plan that satisfies the ACP safe harbor if the plan does not permit employee after-tax contributions. If a defined contribution plan either (i) fails to satisfy the ACP safe harbor or (ii) satisfies the ACP safe harbor but permits employee after-tax contributions, then the special rules that apply when applying traditional ACP testing to a plan that satisfies the ADP safe harbor[112] also apply in determining whether multiple use has occurred.

In determining whether multiple use has occurred with respect to a second plan of an employer, the employer may disregard both a CODA that satisfies the ADP safe harbor and a defined contribution plan that satisfies the ACP safe harbor and does not permit employee after-tax contributions.

### [3] Use of Safe Harbor Contributions In Other Discrimination Testing

Safe harbor contributions may be used to satisfy only certain other non-discrimination tests. For example, safe harbor nonelective

[111] Generally, an employer may elect to take into account matching contributions when applying the ADP test of §401(k)(3). I.R.C. §401(k)(3)(D)(ii)(I) (CCH 2000). However, if the employer makes this election, then those matching contributions may not be taken into account in applying the ACP test. The provision discussed in the text reverses this rule. Thus, if the employer is required to satisfy the ACP test (either because the plan fails to satisfy an ACP safe harbor or because there are after-tax employee contributions which cannot be tested under an ACP safe harbor), then the employer may not elect to treat matching contributions as elective deferrals for purposes of the ADP test. Rather, the employer must take these matching contributions into account in applying the ACP test. *See* I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part VIII.F.3.

[112] *See* Special ACP Testing Requirements, Special Testing Rules Applied if Plan Satisfies ADP Safe Harbor but Traditional ACP Testing is Required *supra* §2.11[1].

contributions used to satisfy the ADP test may also be used to satisfy the nondiscrimination tests of Section 401(a)(4).[113] Safe harbor nonelective contributions may be taken into account in determining whether a plan satisfies the top-heavy minimum contribution requirements, but safe harbor matching contributions may not.[114] Safe harbor nonelective contributions used to satisfy the ADP safe harbor may not be taken into account in determining whether a plan satisfies the permitted disparity (social security integration) requirements.[115]

Finally, as previously noted,[116] safe harbor nonelective and matching contributions used to satisfy the safe harbor ADP test may not be used to satisfy the ACP test. For example, if a plan provides a safe harbor nonelective contribution of 7%, the portion representing the first 3% of the employee's compensation cannot be counted as a qualified nonelective contribution for purposes of satisfying the ACP test, but the portion representing the remaining 4% of employee compensation may be used.

## § 2.12 SAMPLE 401(k) SAFE HARBOR PLANS

We will analyze four sample designs starting with the simplest and increasing in complexity. There are countless variations on each of these designs.

### [1] Ultra Simple 401(k) Safe Harbor Plan Design Using 3% Nonelective Contributions

The most simple 401(k) safe harbor design is a 3% nonelective safe harbor with no matching contributions. Each employee can contribute up to 12% of his or her salary, but not to exceed the 401(k) limit (currently $10,500)[117] All employer contributions are

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[113] Treas. Reg. §1.701(a)(4)-1(b)(2)(ii); I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part VIII.B.

[114] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part VIII.B.

[115] I.R.C. §401(k)(12)(E)(ii) (CCH 2000); I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part VIII.B.

[116] *See* Special ACP Testing Requirements, Special Testing Rules Applied if Plan Satisfies ADP Safe Harbor but Traditional ACP Testing is Required *supra* §2.11[1].

[117] I.R.C. §402(g)(1) (CCH 2000).

100% vested and subject to the 401(k) withdrawal restrictions. There is no 1 year wait for eligibility. No employee after tax contributions are allowed. Assuming the company has the necessary profits and that not all employees contributed up to the 12% level, additional employer contributions can be made up to the amount allowed under the overall 15% deduction limit set forth in Section 404(c). If the comprehensive legislation passed by the House and the Senate becomes law, then the company could increase its profit sharing contribution up to 15%, without having to take into account the 401(k) contributions made by the employees. The reason why the plan design limits employee 401(k) contributions to 12% (which it certainly is not required to do under the law) is so the company does not have to worry about exceeding the 15% overall deduction level. If this limitation is exceeded, 401(k) contributions will have to be returned to employees.

### [2] Integrated Profit Sharing Plan with 3% Nonelective Safe Harbor

This plan design changes the first plan design by integrating the employer's contribution with social security. Because the 3% nonelective safe harbor cannot be used to satisfy permitted disparity under Section 401(l),[118] conceptually one needs to think of this plan as a standard integrated profit sharing plan with an additional 3% nonelective 401(k) safe harbor contribution. The 3% nonelective safe harbor contribution must, of course, be 100% vested, but the regular integrated profit sharing portion can be subject to a vesting schedule. If the plan is top-heavy, the 3% nonelective safe harbor will satisfy the top-heavy rules as long as it is also made on behalf of any non-key employee (i.e., highly compensated employees who are not key employees are not entitled to the 3% nonelective safe harbor, but are entitled to the 3% top-heavy contribution.) All employees could be allowed to make 401(k) contributions up to the maximum 401(k) level or they could be kept to a lower percentage so that the 15% overall deduction limitation is met without having to return 401(k) contributions to employees.

[118] I.R.C. §401(k)(12)(E)(ii) (CCH 2000); I.R.S. Notice 98-52, 1998-46 I.R.B. 16.

### [3] Integrated Profit Sharing Plan with Match Safe Harbor

This plan design would be identical to the second plan design except that instead of using the 3% nonelective contribution to satisfy the safe harbor, the plan would use the match safe harbor. The plan could utilize the basic matching formula so that 401(k) contributions are matched at 100% on the first 3% of compensation deferred and 50% on the next 2% of compensation deferred. Alternatively, the plan could adopt enhanced matching formulas, such as: 100% match on the first 4% of compensation deferred; a 150% match on the first 3% of compensation deferred; or a 125% match on the first 3% and 25% on the next 1% of compensation deferred. This plan would allow employees to make 401(k) contribution either up to the maximum allowed under the law or to a lower percentage so that the plan would not run into any Section 404(c) deduction problems. In no event would the percentage amount allowed by the employees to contribute to the 401(k) plan be lower than that needed to receive the maximum safe harbor match. Other than the peculiar problems presented by the top-heavy rules,[119] this plan design should be relatively easy to operate.

### [4] Cross Tested Profit Sharing Plan with 3% Nonelective Safe Harbor

This is a far more sophisticated plan design than the others and, in the authors' opinion, demands the services of a retirement plan attorney and/or sophisticated third party plan administrator. Assume the plan divides the employees into four groups — employees with more than 20 years of service, employees with more than 10 years of service but less than 20, employees with more than 5 years of service but less than 10 and employees with 5 years of service or less.[120] Further assume, that the first group will receive a 12.5%

[119] For instance, assume a participant does not work 1000 hours so is not eligible for the profit sharing contribution, the participant must still receive the 3% top-heavy contribution unless the participant was not employed on the last day of the plan year.

[120] These groups are simply an example. Groupings can be based on age, on job description as well as on years of service or any combination of these categories. This type of plan design must be tested for nondiscrimination using the rules set forth in the 401(a)(4) regulations. A discussion of the cross testing rules is beyond the scope of this chapter. A cautionary note is needed here — Treasury has made it clear in Notice 2000-14 that it is reviewing what they refer

profit sharing contribution, the second group will receive a 10% contribution, the third a 7% contribution, and the last group will receive a 3% contribution.[121] At least 3% of the employer contribution would have to satisfy the 401(k) safe harbor requirements — 100% vested, given to all participants regardless of hours of service or being employed on the last day of the plan year and subject to the 401(k) withdrawal rules. The remainder of the profit sharing contribution could be subject to a vesting schedule and allocated to employees who had met the 1,000 hours of service and/or last day of the year requirement. The 3% contribution could also satisfy the top-heavy requirement for this plan, if the plan was top-heavy, as long as every non-key employee received a minimum 3% contribution. Employees would be allowed to make 401(k) contributions, in all likelihood limited to a designated percentage, so that the plan would not run afoul of the 404(c) deduction limit.

## § 2.13 THE FUTURE OF THE 401(k) SAFE HARBOR

Treasury is already considering the adoption of the most flexible 401(k) safe harbor design for small businesses possible. This plan design would build upon the one introduced in Notice 2000-3 where a small business does not have to adopt the 3% nonelective safe harbor until 30 days prior to the last day of the plan year. The concept being discussed is to add another alternative for the small business — it could choose to make zero contributions (in which case the key employees could not even make 401(k) contributions to the plan), 2% contributions as in a SIMPLE 401(k) plan (in which case the maximum 401(k) contribution that could be made by an employee is $6,000), or 3% nonelective safe harbor contributions (in which case the maximum 401(k) contribution that could be made by an employee is $10,500). This could be a desirable plan design, but it will take some creative work on the part of Treasury and the

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to as "new comparability." I.R.S. Notice 2000-14, 2000-10 I.R.B. 737. It is hoped that the many valid plan designs utilized by small businesses will not thrown out because of the relatively few abuses in this area.

[121] This formula would have to be tested out based on the company's actual employee census and using the rules set forth in the 401(a)(4) regulations to determine whether it passed the nondiscrimination tests. This is set forth simply as an example and cannot be adopted as a valid plan design without the necessary cross-testing being performed.

person drafting the plan document since the SIMPLE requirements are unique.

It will probably take a good five years to determine whether the 401(k) safe harbors will entice small businesses to enter the qualified retirement plan system. When 401(k) was first added to the Internal Revenue Code, few, if any, understood the plan revolution that was about to take place. Many who believe that the qualified retirement system is ideally situated to bring about real retirement security for millions of Americans hope that the 401(k) safe harbors will bring about a comparable revolution in the formation of small business plans.