

ECCN	Remove	Add
<i>Special Licenses Available</i>	§ 776.18(c).....	§ 778.7(e).
1568A:		
Controls for ECCN heading:		
Reason for Control.....	§ 776.18(a).....	§ 778.7(a)(1).
<i>Special Licenses Available</i>	§ 776.18(c).....	§ 778.7(e).
4568B:		
Controls for ECCN heading:		
Reason for Control.....	§ 776.18(a).....	§ 778.7(a)(1).
1595A:		
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<i>Special Licenses Available</i>	§ 776.18(c).....	§ 778.7(e).
1733A:		
Controls for ECCN heading:		
Reason for Control.....	§ 776.18(a).....	§ 778.7(a)(1).
<i>Special Licenses Available</i>	§ 776.18(c).....	§ 778.7(e).
1746A:		
Controls for ECCN heading:		
Reason for Control.....	§ 776.18.....	§ 778.7(a)(1).
<i>Special Licenses Available</i>	§ 776.18(c).....	§ 778.7(e).
1763A:		
Controls for ECCN heading:		
Reason for Control.....	§ 776.18(a).....	§ 778.7(a)(1).

21. In Supplement No. 1 to § 799.1 (the Commodity Control List), Commodity Group 7 (Chemicals, Metalloids, Petroleum Products and Related Materials), ECCN 4798B is amended by revising the Validated License Required and Special Licenses Available paragraphs, as follows:

4798B Precursor and Intermediate chemicals used in the production of chemical warfare agents.

Controls for ECCN 4798B

Unit: * * *

Validated License Required: All destinations except Australia, Austria, Belgium, Canada, Denmark, the Federal Republic of Germany, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Switzerland, Turkey, and the United Kingdom, except as provided below.

(a) *Sample Shipments:* General License G-DEST is available for one sample shipment of a 55-gallon container (209 liters) or less of each chemical to any one consignee per calendar year (not applicable to Country Groups S and Z, Iran, Iraq, or Syria).

(b) *Compounds:* General License G-DEST is available, except to Country Groups S and Z, and the South African military and police, for compounds that are created from chemicals controlled under this ECCN 4798B provided that the compound itself is not controlled under this ECCN or another ECCN on the CCL. (Mixtures that contain chemicals controlled under this ECCN are controlled as precursors, except when the precursor chemical is merely an impurity that was not intentionally added or is a normal ingredient in

consumer goods intended for retail sales.)

* * * * *

Special Licenses Available: See part 773 of this subchapter.

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Dated: August 9, 1991.

James M. LeMunyon,

Deputy Assistant Secretary for Export Administration.

[FR Doc. 91-19505 Filed 8-14-91; 8:45 am]

BILLING CODE 3510-DT-M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Parts 500 and 589

[Docket No. 87N-0378]

Gentian Violet in Animal Feed; Gentian Violet for Use in Food Animals

AGENCY: Food and Drug Administration, HHS.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending its regulations to declare that gentian violet is neither generally recognized as safe (GRAS) nor prior sanctioned and is a food additive when added to animal feed for any nondrug use. FDA is also amending its regulations to reflect its determination that gentian violet is not GRAS, generally recognized as effective (GRAE), or "grandfathered" under the Drug Amendments of 1962, and is therefore a new animal drug when used for any veterinary drug purpose in food animals. Finally, FDA is revoking its interim policy permitting the use of gentian violet at levels up to 8 parts per

million (ppm) as a mold inhibitor in poultry feed. Continued marketing of gentian violet for use in any food animal species will be permitted only under provision of a food additive regulation or an approved new animal drug application (NADA). There are currently no published food additive regulations or approved NADA's for gentian violet in food animals.

This final rule is based on FDA's conclusion that the criteria for GRAS and GRAE status are not met with respect to the use of gentian violet in food animals. FDA has concluded, based on studies conducted by its National Center for Toxicological Research (NCTR), that gentian violet causes cancer in test animals and that residues of gentian violet occur in the edible tissues of chickens under the current uses.

DATES: This final rule is effective September 16, 1991, at which time manufacturer of gentian violet premixes must cease. The agency's interim policy, adopted July 27, 1982 (47 FR 32480), permitting the use of gentian violet for the prevention of mold growth in poultry feed at up to 8 ppm, is hereby revoked as of September 16, 1991. After the effective date of the final rule, any gentian violet premix intended for use in food-producing animals will be in violation of the Federal Food, Drug, and Cosmetic Act (the act). In order to allow for an orderly phaseout, however, distribution of premixes shall cease by September 30, 1991; and distribution and use of poultry feed containing gentian violet shall cease by October 15, 1991.

FOR FURTHER INFORMATION CONTACT: George Graber, Center for Veterinary Medicine (HFV-220), Food and Drug

Administration, 5600 Fishers Lane,
Rockville, MD 20857, 301-443-4438.

SUPPLEMENTARY INFORMATION:

I. Summaries of and Responses to Comments

In the *Federal Register* of February 13, 1990 (55 FR 5194), FDA proposed that 21 CFR part 500 be amended by establishing new §§ 500.29 and 500.30, respectively, providing that gentian violet is not generally recognized as safe (GRAS) for use in animal feed and is a food additive required to be the subject of a food additive regulation providing for its safe use under section 409 of the act (21 U.S.C. 348), unless its intended use makes it a drug. In that case, gentian violet is a new animal drug required to be the subject of an approved NADA under section 512 of the act (21 U.S.C. 360b). In addition, FDA proposed to amend 21 CFR part 589 by establishing a new § 589.1000 listing gentian violet as a substance prohibited from use in animal food or feed.

The proposal provided 60 days for interested persons to comment. The agency received 15 comments on the proposal—8 from poultry producer organizations, 2 from manufacturers of gentian violet, 2 from distributors of animal health products including gentian violet, and 1 each from a poultry producer, a veterinarian, and a state department of agriculture. All the responses opposed the proposed action. However, only one of the comments submitted documents, data, and other supporting information that responded directly to the issues addressed in the proposal.

None of the comments submitted or provided citations to published studies that would support the contention that gentian violet is GRAS from a human food safety standpoint. In the preamble to the proposal, FDA reported not only the existence of studies (mostly unpublished) showing that gentian violet is an animal carcinogen, but FDA also reported a scarcity of the kinds of published studies required to support an expert opinion that gentian violet is GRAS based on scientific procedures. The agency's literature search generally found that the published literature that does exist demonstrates that gentian violet tends to have mutagenic, genotoxic, and other toxic properties (55 FR 5194 at 5201). The agency also described studies, published and unpublished, that demonstrate that residues of gentian violet occur in edible portions of chicken after administration of the substance to poultry (55 FR 5194 at 5198 and 5200).

Thus, the comments failed to refute the agency's initial conclusion that the foundation upon which a finding of general recognition of safety by experts must rest—that is, published literature establishing the safety of the substance for use in animal feed—does not exist. Further, none of the comments were from persons who purported to be qualified experts, and none of the comments contained statements from experts that gentian violet is GRAS based on published studies. One comment, from Cambridge Products, Ltd., a gentian violet premix distributor, and Naremc, Inc., a gentian violet premix manufacturer, contained the curriculum vitae of consultants who are employed by consulting firms and a private testing laboratory that have provided services to Cambridge and Naremc in connection with gentian violet. (For the sake of convenience, the two firms are referred to hereafter as Cambridge Naremc.) However, the comment did not contain any statement from any of those consultants to the effect that gentian violet is GRAS based on published literature. None of the comments challenged on sound scientific grounds FDA's conclusion that gentian violet has been shown to be an animal carcinogen, but a comment argued that the substance is a weak carcinogen rather than a potent carcinogen as FDA contended in the proposal.

None of the comments claimed that gentian violet is GRAS on the basis of common use in food prior to January 1, 1958. Also, none of the comments contended that gentian violet is prior sanctioned for any use in animal feed. Finally, none of the comments provided any support for the contention that gentian violet is GRAS and GRAE for animal drug use, and none of the comments contended that gentian violet is grandfathered under the 1962 grandfather clause, as reflected in section 108(b)(3) of the Animal Drug Amendments of 1968, Public Law 90-399, 82 Stat. 342 (1968).

A summary of the comments received and FDA's responses are as follows:

1. One comment contended that there is enough information, available to the public, to support GRAS status for gentian violet. The comment referred to data and information concerning risk assessments for gentian violet, a regulatory method and target animal safety. The comment noted that the data and information concerning risk assessment and a regulatory method had been placed in the FDA docket on this matter, and had been cited in *Food Chemical News* and another trade

publication. The comment also submitted literature citations concerning studies related to target animal safety. The comment contended that filing documents in the docket, and referring to documents in a trade publication, essentially constitute publication for the purpose of a GRAS determination.

The comment ignored the need for published studies concerning the underlying safety issues in this proceeding, namely, gentian violet's toxicity and the amount and kind of residues that occur in human food (55 FR 5194 at 5195 through 5196 and sources cited there). Furthermore, the agency disagrees with the comment's contention that filing documents in the docket, and providing reference to the documents in trade publications, constitute publication for the purpose of a GRAS determination. Published studies are needed for general recognition based on scientific procedures, because the results of the studies must be generally available to experts. *Id.* See also *United States v. Seven Cardboard Cases* * * * "100 Capsules NDC * * * *Esgic* * * * with Codeine Capsules, etc." and *Forest Pharmaceuticals, Inc.*, 716 F. Supp. 1221, 1223-1225 (E.D. M. 1989) and cases cited there (hereafter referred to as *Esgic*). Publication in the scientific literature ordinarily makes sufficient details from a study readily available for peer review, so that experts in the applicable field may form an opinion as to the safety of the substance. See 55 FR 5194 at 5195 through 5196; *Esgic*, 716 F. Supp. at 1224-1225 and cases cited there; *United States v. 118/100 Tablet Bottles, etc.*, 662 F. Supp. 511, 513 (W.D. La.) ("Unless * * * data are made available to the community of experts and thereby subject to peer evaluation, criticism, and review, a consensus among experts cannot be reached. Consequently, the requisite * * * investigations must be published in the scientific literature and thus be made available generally to experts * * *").

The methods proposed by the comment do not accomplish that purpose. Although published studies may be corroborated by unpublished studies and other data and information, there must be sufficient published studies to permit experts to form an opinion that a substance is safe. In this case, neither the comments nor FDA's literature reviews disclosed the existence of such studies. (The published literature concerning target animal safety referred to by this comment is discussed in section I, paragraph 6 of this preamble.)

2. One comment asserted that the risk of cancer in humans from the use of gentian violet in poultry feed is less than 1 in 1 million. The comment noted that the standard for GRAS status is the same as that for premarket approval and that the premarket approval standard for a carcinogenic animal food additive is an additional lifetime cancer risk of less than 1 in 1 million, and claimed that the use of gentian violet in poultry feed at a level of 8 ppm meets the latter standard. Therefore, according to the comment, the use of gentian violet in poultry feed at a level of 8 ppm is GRAS. The comment, from Cambridge Naremcro, was accompanied by a copy of a gentian violet food additive petition that Cambridge Products, Ltd., had submitted earlier to the agency. The firms base their risk assessment calculation on a residue study for them and on food consumption factors that differ from those used by FDA in making assessments for animal food additives.

FDA agrees that the scientific standards for GRAS status and premarket approval are the same. The procedures by which the two determinations are made, however, are distinctly different. GRAS status is established from a determination of the opinions of experts as to the substance's safety, and the opinions must be based on published literature. Premarket approval is based on a FDA review of data and information, ordinarily unpublished, submitted in a food additive petition. By submitting a copy of their food additive petition in this proceeding, and by relying primarily on unpublished data, Cambridge Naremcro have essentially asked the agency to obliterate the distinction between GRAS determinations and actions on food additive petitions.

The comment therefore has not established that, based on published literature, experts generally recognize that the use of gentian violet in poultry feed causes an additional risk of cancer of less than 1 in 1 million. Because the comment has not made even a *prima facie* case, it is unnecessary for the agency to respond to the comment's contention that the agency uses incorrect food consumption factors in its approval decisions. In any event, a challenge to preapproval standards can properly be raised only in the context of a premarket approval proceeding, e.g., action on a food additive petition.

3. Several comments argued that FDA should allow gentian violet to stay on the market because the substance has a long history of safe use both in animal feed and human medicine.

A history of safe use does not provide a legal basis for adding a substance to

food, unless the substance is GRAS based on common use in food prior to January 1, 1958. As explained in the narrative preceding the numbered paragraphs and in section I, paragraph 1 of this preamble, however, none of the comments submitted information to support GRAS status of gentian violet based on common use in food prior to January 1, 1958. Moreover, the public is exposed indiscriminately to food additive residues, and the elapsed time between exposure to a carcinogen and the development of tumors may be years. Thus, it is virtually impossible to assess the safety of a carcinogen based solely on its history of use. Finally, as pointed out in the proposal (55 FR 5194) the internal use of gentian violet in human medicine in this country today is extremely limited.

4. One comment stated that, as a matter of law, a substance can be a carcinogen and at the same time be GRAS.

The agency agrees that, in theory, a carcinogen can be GRAS. However, the agency remains firmly committed to its position, stated in the preamble to the proposal (55 FR 5194 at 5196) that, as a practical matter, such recognition is unlikely because of the requirement that the data and information needed to support GRAS status be published and generally available to experts. The comment, by Cambridge Naremcro, did not challenge the agency's explanation but instead contended that it tended to support Cambridge Naremcro's position that the agency is not willing to review their scientific data and analysis in a fair and impartial manner. This latter allegation is addressed in section I, paragraph 8 of this preamble.

5. One comment, from Cambridge Naremcro, contended that there are serious shortcomings in the toxicological studies conducted by the NCTR that were cited by FDA in its proposal. The comment did not describe the alleged shortcomings, but instead attached copies of letters Cambridge Products, Ltd., had written to the agency commenting on the studies.

The agency responded to Cambridge Naremcro's criticisms, in 1987, 1988, and 1989 in letters to Cambridge Products, Ltd. (Refs. 1 through 8). These letters are referred to in paragraph 8 of this preamble. The agency notes that, in its food additive petition, Cambridge relies on all the NCTR studies except one in support of its contention that gentian violet is safe, thus conceding the validity of the studies.

6. One comment submitted references to six published articles to show that gentian violet is GRAS to the target animal, i.e., poultry.

The agency has reviewed the literature cited by the comment, and has found that these studies were not adequately designed for the purpose of assessing the safety of gentian violet to poultry. Although the work of Cross and Hughes in breeder chickens addressed some safety parameters, this study did not include a control group, and neither a histopathological analysis of reproductive tissues of the parent nor a teratological analysis of the offspring was completed. The research of Stewart and colleagues also does not qualify as a safety study. The studies conducted by these researchers evaluated gentian violet for its growth promotion and pharmacologic activity. The study by Churchman and Herz cited by the comment provided only a general description of studies in which rabbits and dogs received gentian violet intravenously, and the work reported by Cutlip and Monlux was with dogs and cattle. The study by Kingsland and Anderson addressed the utility of gentian violet, and not its safety. In the work reported by Veltman and Jensen, gentian violet's toxicity was not being studied. Rather, these researchers were investigating the effects of certain feed additives on the incidence of a bone ailment in poultry, and gentian violet was one of the additives studied.

The studies referred to by the comment fail to show that gentian violet is safe for poultry. Furthermore, the lack of published studies assessing safety in the target animal species precludes a finding of general recognition of safety to poultry.

7. Several comments asserted that the agency could not, by issuing a regulation, "overrule" the 1981 decision in the United States District Court for the Northern District of Georgia to the effect that gentian violet is GRAS under certain conditions of use.

The comments did not provide any authority to support their position. It is beyond question that a court may grant relief from the continuing effects of a judgment because of a change in the operative facts, in this case, the scientific information that is available concerning the safety of gentian violet. Put another way, current general recognition must be proved in order to avoid the requirement of premarket approval. See *United States v. Wester Serum Co., Inc.*, 666 F. 2d 335, 339-341 (9th Cir. 1982).

8. Several comments asserted the agency had treated Cambridge Naremcro unfairly with respect to the firms' attempts to market gentian violet. With the exception of the allegation concerning general recognition of a

carcinogen, discussed in section I, paragraph 4 of this preamble, the comments did not provide specific examples to support their contentions.

FDA believes that the agency has treated Cambridge NaremcCo fairly. The assertions are irrelevant to the question whether gentian violet is GRAS for animal food use. Furthermore, although the burden of conducting studies to support a food additive petition is on the marketer of the product, see, e.g., section 409(b)(2) of the act, FDA took the extraordinary step of conducting safety studies on gentian violet (the NCTR studies) at Government expense. The results of these studies are available to any party, and have been used by Cambridge Products, Ltd., in support of its food additive petition. In addition, in 1981 FDA voluntarily entered into a stipulated stay order that permitted NaremcCo to resume the marketing of gentian violet. (NaremcCo, Inc., was enjoined in 1977 from marketing gentian violet (55 FR 5194 at 5195).) Thereafter, between 1981 and 1989, in the context of the stipulated order, the agency devoted hundreds of hours responding in detail to Cambridge Products, Ltd.'s, criticisms of the NCTR studies. (Cambridge's comments on the NCTR studies were submitted to FDA in accordance with the procedure established in the stay order.) See, e.g., Refs. 1 through 8. Moreover, FDA voluntarily permitted Cambridge NaremcCo to continue to market their gentian violet products until the issuance of a final rule, even though the agency could have asked the court to reinstate the injunction against NaremcCo's marketing of gentian violet.

9. Several comments contended that FDA should study the benefits and the risks of the use of gentian violet before deciding whether to adopt the proposed regulation.

FDA may not and does not take benefits into account when making food additive determinations and decisions. See "Diethylstilbestrol; Withdrawal of Approval of New Animal Drug Applications; Commissioner's Decision," in the Federal Register of September 21, 1979, 44 FR 54852 at 54882 through 54883.

10. A number of comments argued that the agency's economic analysis is wrong, on the ground that propionic acid is not a viable alternative (as the agency had assumed) because of an alleged lack of effectiveness, corrosiveness, higher cost, and increases in the growth of molds and mycotoxin levels in animal feed as a result of its use. One comment, relying on two journal articles, claimed that the use of propionic acid could result in increases in mycotoxin levels in feeds.

Only one comment, by Cambridge NaremcCo, submitted an alternative economic analysis, and that analysis assumed that there were no alternatives available. None of the comments submitted documentation to support Cambridge NaremcCo's position concerning propionic acid, or their contention that no other alternatives are available. Propionic acid and its various salts are used by the feed industry as mold inhibitors in poultry feed, and firms are marketing noncorrosive propionic acid products. Further, the alleged increase in mycotoxin levels resulting from propionic acid use is without foundation.

FDA believes the two journal articles are of questionable value because, for example, the work was not done in grain or feed but rather in a liquid medium. No aflatoxin (a mycotoxin) was detected in the poultry feed regardless of the level or presence of propionic acid, according to one of the articles.

Thus, the economic impacts projected by Cambridge NaremcCo are tremendously inflated and, as such, are without merit.

In response to the comments, the agency has reexamined its economic assessment and made minor changes, but the estimated annual impact remains at \$5.1 million, which does not approach the threshold for a "major rule" under Executive Order 12291. The economic impact of the rule is discussed in greater detail in section II. B. A copy of the revised assessment supporting the agency's determinations is on file with the Dockets Management Branch (HFA-305), Food and Drug Administration, Rm. 1-23, 12420 Parklawn Dr., Rockville, MD 20857.

11. One comment stated that FDA had not adequately addressed the environmental impact of the proposal because it failed to consider the environmental impacts of the alternative products.

The agency disagrees with this comment, and concludes that its environmental assessment adequately considers the alternative products, in particular the propionic-based products. The environmental impacts of propionic acid and its salts are expected to be identical to each other when used in feeds for animals. As noted in section I, paragraph 10 of this preamble, noncorrosive salts of propionic acid are on the market.

12. One comment argued that FDA should withdraw the proposed rule or, at a minimum, hold the rulemaking in abeyance pending approval of gentian violet as a food additive.

FDA disagrees. It is publishing the final rule for the reasons discussed throughout this preamble. Cambridge products, Ltd.'s, food additive petition is pending before the agency, which has provided the firm a detailed explanation (Ref. 9) of why the petition is inadequate to serve as the basis of the requisite food additive regulation for gentian violet. There is thus no reason to hold this rulemaking proceeding in abeyance pending the outcome of the food additive proceeding.

13. On its own initiative, FDA has made several minor clarifying changes in the text of the regulations. For example, in § 589.1000, the agency has added language clarifying that gentian violet is not prohibited from use in animal food and feed if it is covered by an effective notice of claimed investigational exemption for a food additive under 21 CFR 570.10 or for a new animal drug under 21 CFR part 511.

In summary, after careful consideration of the comments, FDA has concluded that;

1. Gentian violet is not GRAS for use in animal feed and is a food additive subject to section 409 of the act.

2. Gentian violet is not prior sanctioned for use in animal feed.

3. Gentian violet is not GRAS or GRAE for any veterinary drug use, and therefore is a new animal drug subject to section 512 of the act. Gentian violet is not "grandfather" under provisions of the Drug Amendments of 1962.

This final rule is effective September 16, 1991, at which time manufacture of gentian violet premixes must cease. The agency's interim policy, adopted July 27, 1982 (47 FR 32480), permitting use of gentian violet for the prevention of mold growth in poultry feed at up to 8 ppm, is hereby revoked as of September 16, 1991.

After the effective date of the final rule, any gentian violet premix intended for use in food-producing animals will be in violation of the act, unless covered by a food additive regulation or an effective notice of claimed investigational exemption for a food additive. (If gentian violet is intended for use as a new animal drug, it must be the subject of an approved new animal drug application or an effective notice of claimed investigational exemption for a new animal drug.) In order to allow for an orderly phaseout, however, distribution of premixes shall cease by September 30, 1991; and distribution and use of poultry feed containing gentian violet shall cease by October 15, 1991.

The phase-out schedule that the agency has established for gentian violet in animal feed is consistent with the

applicable provision of the Administrative Procedure Act, 5 U.S.C. 553(d), and past FDA practice. Alternatives to gentian violet are available, and have been in use for a number of years. The agency's intention to require discontinuation of the use of gentian violet has been known to the industry for several years, so the industry has had adequate time to prepare. In view of the fact that gentian violet has been shown to be a potent animal carcinogen, the FDA has concluded that any further delay in implementation of the final regulation would be inappropriate.

II. Environmental and Economic Impact

A. Environmental Impact

The agency has carefully considered the potential environmental effects of this action. FDA has concluded that the action will not have a significant impact on the human environment, and that an environmental impact statement is not required. The agency's finding of no significant impact and the evidence supporting the finding are contained in an environmental assessment which may be seen in the Dockets Management Branch (address above) between 9 a.m. and 4 p.m., Monday through Friday.

B. Economic Impact

In response to comments submitted, the agency has reexamined the economic impact of the final regulation in accordance with Executive Order 12291 and the Regulatory Flexibility Act (Pub. L. 96-354). FDA estimates that gentian violet is added to roughly 40 percent of poultry food. The 60 percent not treated with gentian violet may either be treated with alternative mold inhibitor or no mold inhibitor. The agency expects most poultry producers who currently use gentian violet as a mold inhibitor to switch to an alternative mold inhibitor, e.g., propionic acid and its salts. As poultry producers switch from gentian violet to propionic acid, the production costs will increase, since propionic acid is usually more expensive. FDA estimates that a total annual nationwide cost of \$5.1 million or less will be incurred by those who switch. This cost increase reflects the difference in price between propionic acid and gentian violet. However, this cost increase may be mitigated if the alternative mold inhibitor is more effective than gentian violet (assuming that gentian violet is an effective mold inhibitor.)

There is some imprecision in the \$5.1

million cost estimate, because the agency believes that a portion of gentian violet users employ the compound to treat fungal infections rather than to inhibit mold growth. Treating fungal infections with gentian violet is an unapproved drug use. If poultry producers who use gentian violet for treating fungal infections switch to a therapeutic agent approved for this use (nystatin), they may realize a savings as a result of lower disease-related losses. However, these potential savings could be partially or totally offset by the difference in price between the two compounds. Based on its examination, FDA concludes that the economic effects attributable to the proposed regulation do not warrant its treatment as a major rule as defined in Executive Order 12291.

With regard to the Regulatory Flexibility Act, the agency finds that this regulation will affect about 10 to 15 firms in the mold inhibitor manufacturing industry. Most of these firms are small businesses which currently produce and/or market alternative mold inhibitors; therefore, their lost gentian violet sales will probably be replaced by sales of other products, resulting in minimal impacts. However, it is possible that a few of these firms, for whom gentian violet mold inhibitor is a major source of revenue, may suffer losses due to the regulation. The regulation will also affect several hundred distributors and dealers who carry gentian violet as part of their product lines. However the regulation's impact on distributors and dealers will be almost imperceptible, because they also are expected to replace the lost gentian violet with sales of alternative mold inhibitors. Therefore, the proposed regulation will not have a significant effect on a substantial number of firms, and it does not warrant a regulatory flexibility analysis under Pub. L. 96-354.

A copy of the assessment supporting these determinations is on file with the Dockets Management Branch (address above).

III. References

The following references, together with the documents cited in the preamble, have been placed on display in the Dockets Management Branch (address above) and may be seen by interested persons between 9 a.m. and 4 p.m., Monday through Friday.

1. Letter of July 9, 1987, from John A. Norris, Deputy Commissioner, FDA, to Jack L. Radlo, Chairman, Cambridge Products, Ltd.

2. Letter of November 27, 1987, from Gerald B. Guest, Director, Center for Veterinary Medicine, to Jack L. Radlo, chairman of the board, Cambridge Products, Ltd.

3. Letter of January 12, 1988, from Gerald B. Guest, Director, Center for Veterinary Medicine, to Jack L. Radlo, chairman of the board, Cambridge Products, Ltd.

4. Letter of February 1, 1989, from Gerald B. Guest, Director, Center for Veterinary Medicine, to Jack L. Radlo, chairman of the board, Cambridge Products, Ltd.

5. Letter of March 29, 1989, from Gerald B. Guest, Director, Center for Veterinary Medicine, to Jack L. Radlo, chairman of the board, Cambridge Products, Ltd.

6. Letter of July 21, 1989, from Gerald B. Guest, Director, Center for Veterinary Medicine, to Jack L. Radlo, chairman of the board, Cambridge Products, Ltd.

7. Letter of December 6, 1989, from Gerald B. Guest, Director, Center for Veterinary Medicine, to Jack L. Radlo, chairman of the board, Cambridge Products, Ltd.

8. Letter of December 6, 1989, from Gerald B. Guest, Director, Center for Veterinary Medicine, to Jack L. Radlo, chairman of the board, Cambridge Products, Ltd.

9. Letter of December 14, 1990, from George Graber, Director, Division of Animal Feeds, Center for Veterinary Medicine, to Jack L. Radlo, chairman of the board, Cambridge Products, Ltd.

List of Subjects in 21 CFR

Part 500

Animal drugs, Animal feeds, Cancer, Labeling, Polychlorinated biphenyls (PCB's).

Part 589

Animal feeds, Animal foods, Food additives.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs, 21 CFR parts 500 and 589 are amended as follows:

PART 500—GENERAL

1. The authority citation for 21 CFR part 500 continues to read as follows:

Authority: Secs. 201, 301, 402, 403, 409, 501, 502, 503, 512, 701 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 321, 331, 342, 343, 348, 351, 352, 353, 360b, 371).

2. New §§ 500.29 and 500.30 are added to subpart B to read as follows:

§ 500.29 Gentian violet for use in animal feed.

The Food and Drug Administration has determined that gentian violet is not generally recognized as safe for use in animal feed and is a food additive subject to section 409 of the Federal Food, Drug, and Cosmetic Act (the act).

unless it is intended for use as a new animal drug, in which case it is subject to section 512 of the act. The Food and Drug Administration has determined that gentian violet is not prior sanctioned for any use in animal feed.

§ 500.30 Gentian violet for animal drug use.

The Food and Drug Administration (FDA) has determined that gentian violet is not generally recognized as safe and effective for any veterinary drug use in food animals and is a new animal drug subject to section 512 of the Federal Food, Drug, and Cosmetic Act. FDA has determined that gentian violet is not exempted from new animal drug status under the "grandfather" provisions of the Drug Amendments of 1962 (21 U.S.C. 342).

PART 589—SUBSTANCES PROHIBITED FROM USE IN ANIMAL FOOD OR FEED

3. The authority citation for 21 CFR part 589 continues to read as follows:

Authority: Secs. 201, 402, 409, 701 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 321, 342, 348, 371).

4. New subpart B consisting of § 589.1000 is added to read as follows:

Subpart B—Listing of Specific Substances Prohibited From Use in Animal Food or Feed

§ 589.1000 Gentian violet.

The Food and Drug Administration has determined that gentian violet has not been shown by adequate scientific data to be safe for use in animal feed. Use of gentian violet in animal feed causes the feed to be adulterated and in violation of the Federal Food, Drug, and Cosmetic Act (the act), in the absence of a regulation providing for its safe use as a food additive under section 409 of the act, unless it is subject to an effective notice of claimed investigational exemption for a food additive under § 570.17 of this chapter, or unless the substance is intended for use as a new animal drug and is subject to an approved application under section 512 of the act or an effective notice of claimed investigational exemption for a new animal drug under part 511 of this chapter.

Dated: February 22, 1991.

David A. Kessler,

Commissioner of Food and Drugs.

[FR Doc. 91-19381 Filed 8-14-91; 8:45 am]

BILLING CODE 4160-01-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[T.D. 8357]

RIN 1545-A179

26 CFR Parts 1, 54, and 602

Certain Cash or Deferred Arrangements and Employee and Matching Contributions Under Employee Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to certain cash or deferred arrangements (CODAs) and employee and matching contributions under employee plans. They generally reflect changes in the applicable tax law made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, and the Omnibus Budget Reconciliation Act of 1989. The regulations provide the public with the guidance needed to comply with the law and affect sponsors of plans that contain cash or deferred arrangements or employee or matching contributions, and employees who are entitled to make elections under these plans.

EFFECTIVE DATES: These regulations are effective as follows:

Section 1.401(a)-30, Plan years beginning after December 31, 1987.

Section 1.401(k)-0, Plan years beginning after December 31, 1979.

Section 1.401(k)-1, Plan years beginning after December 31, 1979, except as otherwise stated in paragraph (h) of the section.

Section 1.401(m)-0, Plan years beginning after December 31, 1986.

Section 1.401(m)-1, Plan years beginning after December 31, 1986.

Section 1.401(m)-2, Plan years beginning after December 31, 1988.

Section 1.402(a)-1(d), Taxable years beginning after June 27, 1974.

Section 1.402(g)-0, Taxable years beginning after December 31, 1986.

Section 1.402(g)-1, Taxable years beginning after December 31, 1986.

Amendment to § 1.411(a)-4, Taxable years beginning after December 31, 1986.

Section 1.411(d)-4, A-2(b)(2)(x), Plan amendments made after July 30, 1984.

Section 1.411(d)-4, A-2(b)(2)(xi), Limitation years beginning after December 31, 1986.

Amendment to § 1.415-6, Plan years beginning after December 31, 1986.

Amendment to § 1.416-1, Plan years beginning after December 31, 1986.

Section 54.4979-0, Plan years beginning after December 31, 1986.

Section 54.4979-1, Plan years beginning after December 31, 1986.

Amendment to § 602.101(c), August 15, 1991.

Portions of these regulations become applicable to various taxpayers and plans as of dates other than the effective dates listed above.

FOR FURTHER INFORMATION CONTACT: Catherine Livingston Fernandez, at 202-377-9372 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control numbers 1545-1069 and 1545-1039.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents/recordkeepers may require greater or less time, depending upon their particular circumstances. The estimated annual burden per respondent/recordkeeper varies from 30 minutes to 4.5 hours, depending on individual circumstances, with an estimated average of 2.1 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Washington, DC 20224, attention: IRS Reports Clearance Officer, and to the Office of Management and Budget, attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On November 10, 1981, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 401(k) and 402(a)(8) of the Internal Revenue Code (Code), 46 FR 55544. The amendments were proposed to conform the regulations to section 135 of the Revenue Act of 1978, Public Law No. 95-600, 92 Stat. 2763, 2785 (1978). Final regulations were issued on August 8, 1988, 53 FR 29658. At the same time, additional amendments to the Income Tax Regulations were proposed under sections 401(k), 401(m), 402(g), 414(q), 414(s), 415, 416, and 4979 of the Code, 53 FR 29719. These amendments were

proposed to conform the regulations to sections 1105, 1116, and 1117 of the Tax Reform Act of 1986 (TRA '86). Further guidance on CODAs and employee and matching contributions was provided by Notice 88-127, 1988-2 C.B. 538, and Revenue Procedure 89-65, 1989-2 C.B. 786. The proposed regulations were modified on May 14, 1990, 55 FR 19947, to simplify the calculation for aggregating family members, and to modify the multiple use limitation. Additional guidance applicable to defined contribution plans, including those with CODAs and employee and matching contributions, was contained in proposed regulations under section 401(a)(4) published on September 14, 1990, 55 FR 37888.

A public hearing on the 1988 proposed regulations was announced on January 27, 1989, 54 FR 4045, and held on March 14, 1989. A public hearing on the regulations proposed on May 14, 1990, was held on September 26-28, 1990.

The Department of the Treasury and the Internal Revenue Service have considered all of the comments regarding the 1988 proposed and final regulations. This Treasury Decision consolidates the 1988 proposed and final regulations, with modifications, into a complete set of regulations providing comprehensive guidance on qualified CODAs, and employee and matching contributions. These regulations replace all of the 1988 proposed and final regulations on these subjects, and the amendments to regulations under section 401 (k) and (m) issued on May 14, 1990. They consolidate and reorganize the regulations in order to improve their comprehensiveness and readability. Furthermore, they reflect subsequent statutory changes, simplify certain aspects of the existing requirements, and provide needed guidance on other aspects of qualified CODAs and employee and matching contributions.

Qualified Cash or Deferred Arrangements and Employee and Matching Contributions

1. Limit on Elective Deferrals

The Technical and Miscellaneous Revenue Act of 1988, Public Law No. 100-647 (TAMRA), section 1011(c)(7)(A), enacted Code section 401(a)(30). Section 401(a)(30) makes the dollar limit imposed on elective deferrals under section 402(g) a qualification requirement for plans maintained by the same or related employers. Section 1.401(a)-30 has been added to the regulations to reflect this requirement. As a result, plans must be amended to restrict a participant's elective deferrals

for a taxable year to the dollar limit in effect for that taxable year. The limit is imposed on the participant's combined elective deferrals under all plans, contracts, or arrangements of the employer maintaining the plans and all related employers.

If an individual defers more than the maximum for a taxable year under plans of two or more unrelated employers, generally none of the plans is disqualified due to the excess. The individual may not, however, exclude the excess deferrals from gross income. Also, unless the excess deferrals are timely corrected under section 402(g)(2), they are taxed again when distributed from the plan, since they do not increase the employee's investment in the contract under section 72.

On the other hand, if an individual defers more than the maximum under a single plan or under plans of the same or related employers, the plan or plans are all generally disqualified. However, final regulations under section 402(g) provide that corrective distributions for purposes of section 402(g) under one or more plans of the same or related employers also prevent disqualification in operation under section 401(a)(30). In these cases, the plan or plans may provide that the employee is deemed to have made the designation normally required for the distribution of excess deferrals, or that the employer may make the designation.

Excess deferrals (whether they occur under plans of unrelated employers or under a plan or plans of the same or related employer) distributed to a highly compensated employee are taken into account in determining the employee's actual deferral ratio for the plan year for which they were contributed. Excess deferrals distributed to a nonhighly compensated employee are not taken into account if they were under a plan or plans of the same or related employers.

2. Partnership Cash or Deferred Arrangements

The 1988 proposed regulations clarified that partnerships could maintain cash or deferred arrangements (CODAs) covering partners. It also provided that an arrangement that directly or indirectly permitted individual partners to vary the amount of contributions made on their behalf was a CODA. Under the 1988 proposed regulations, any elective contributions under this type of arrangement were after-tax contributions (i.e., not deductible by the partners) if the arrangement was not a qualified CODA. If the arrangement was a qualified CODA, the amount of elective contributions that a partner could

deduct for any taxable year was limited under section 402(g). This limit is \$8,475 for taxable years beginning in 1991.

Many commentators were concerned about plans providing a fixed rate of contributions for all partners and employees but allowing each partner to elect not to participate or to have a smaller percentage of compensation contributed by the partnership on the partner's behalf. For example, some plans provided for contributions equal to 10 percent of compensation for each partner or employee, but permitted any partner to elect to have no contribution (or a contribution of less than 10 percent) made. The commentators argued that these plans should not be treated as CODAs because they result in lower contribution rates for partners (generally the more highly compensated participants) than for employees. They also noted that before the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), plans were required to allow owner-employees to elect not to participate. Many partnerships maintained plans with these provisions for many years and continued them after TEFRA repealed this requirement.

The final regulations continue to provide that any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf is a CODA. Neither the Revenue Act of 1978 (sections 131-135), the legislative history of that Act, nor later legislation relating to section 401(k) provides a statutory basis for permitting self-employed individuals to defer compensation on an elective, pre-tax basis under a qualified plan except as provided under section 401(k). In addition, to permit partners to defer more than the section 402(g) limit on an elective, tax-favored basis would provide partnerships with a significant advantage over corporations. This would be inconsistent with TEFRA's policy establishing parity between plans covering partners and those covering other employees.

A partnership, like any other employer, may allow each of its employees (including partners, who are treated as employees under section 401(c)) to make a one-time irrevocable election, upon commencement of employment or initial eligibility under any plan of the employer, to have a specified amount or percentage of compensation (including no amount) contributed by the employer throughout the employee's employment. This permits employees to elect different rates of employer contributions, but the arrangement is not treated as a CODA. See § 1.401(k)-1(a)(3)(iv). These

employer contributions must satisfy section 401(a)(4), without relying on the actual deferral percentage (ADP) or actual contribution percentage (ACP) test. Since the contributions are not treated as elective, they are subject to neither the vesting and distribution restrictions under section 401(k), nor the section 402(g) limit on elective contributions.

Notice 88-127, 1988-2 C.B. 538, gave partnership plans until the later of March 31, 1989, or the first day of the first plan year beginning after December 31, 1988, either to be amended to become qualified CODAs or to require employees and partners to make one-time irrevocable elections. The latter approach permitted current employees and partners, as well as new ones, to make one-time irrevocable elections without causing the plan to become a CODA. The final regulations include this provision. Of course, the partnership could instead have amended the plan to eliminate the election within the specified time.

Many partnerships may have missed the deadline for requiring elections to take advantage of this relief, thereby jeopardizing the qualification of their arrangements or plans. To enable these partnership plans to avoid disqualification, the Service is issuing Rev. Proc. 91-47, to be published in Internal Revenue Bulletin 34, dated August 26, 1991. This Revenue Procedure gives limited relief to partnership plans that missed the deadline. It provides that the Service will not disqualify the plans or the CODAs if certain steps are taken during the section 401(b) remedial amendment period.

The 1988 proposed regulations were generally effective for plan years beginning after 1986. Many partnerships objected that the general effective date would have applied these requirements to their plans retroactively. In response, as announced in Notice 88-127, 1988-2 C.B. 538, the final regulations provide that § 1.401(k)-1(a)(6)(ii) is effective for contributions to partnership plans for plan years beginning after 1988.

A number of commentators requested that the Service clarify the timing of a partner's election to defer compensation. Under section 704, a partner's distributive share of partnership income is determined as of the last day of the partnership's taxable year, and the partner is taxed on the distributive share in the partner's taxable year in which the partnership's taxable year ends, whether or not it is actually distributed. Some commentators asked whether the cash or deferred election had to be made before the partner was entitled to

receive a draw of partnership income (which would be reduced by the election). Other commentators asked whether the election had to be made by the end of the partnership's taxable year or could be delayed until the deadline for filing the partnership's tax return. The tax return deadline was suggested because each partner's precise share of partnership income may not be known until the return is filed. The final regulations follow the suggestion of some commentators that the election may be made at any time before the end of the partnership's taxable year (since that is the date on which, but for the election, the compensation would be includible in the partner's taxable income). However, the election may not be made after the end of that taxable year. In addition, for plan years beginning before January 1, 1992, a plan may permit a partner to make a cash or deferred election until the due date, including extensions, for filing the partnership's Federal income tax return for its taxable year ending with or within the plan year.

Many commentators observed that § 1.401(k)-1(a)(6)(iii) of the 1988 proposed regulations had the effect of treating all matching contributions on behalf of partners as elective contributions. Under that provision, a matching contribution on behalf of a partner was treated as an elective contribution if the partnership deduction for the contribution was allocated to the partner. Section 1.404(e)-1A(f) of the regulations, however, requires that a partnership allocate the deduction for all contributions to a defined contribution plan on behalf of a partner to that partner. Accordingly, under the 1988 proposed regulations it was impossible for a partnership to make a matching contribution on behalf of a partner without having the contribution treated as elective.

This result was not intended. The Treasury and the Service agree that partnership CODAs should be permitted to contain matching contributions for partners that are not treated as elective deferrals, but continue to believe that a matching contribution that is deducted solely by the partner who benefits from it is properly characterized as an elective contribution.

One commentator suggested that § 1.404(e)-1A(f) of the regulations be amended to allow matching and other contributions on behalf of a partner to be made and deducted by partners other than the partner to whose plan account the contributions are allocated. This proposal has received serious consideration by the Treasury and the Service.

Developing additional deduction rules for matching and other contributions by partners raises a number of significant issues involving the interaction of plan qualification and partnership rules. One issue is whether alternative methods are appropriate for determining a partner's distributive share of contributions on behalf of partners, and deductions for these contributions. A second issue is whether some or all qualified plan contributions on behalf of partners should be treated as guaranteed payments under section 707(a). In addressing these issues, consideration must, of course, be given to the appropriate implementation of the deduction limitations of section 404 in the partnership context, and to the effect of the alternative methods on the determination of the partner's earned income under section 401(c)(2).

Because of the complexity of these issues, no change in § 1.404(e)-1A(f) of the regulations is made at the present time. However, comments are specifically requested concerning appropriate changes to § 1.404(e)-1A(f) and related regulations.

3. Aggregation Rules

a. Employee Stock Ownership Plans (ESOPs)

There were numerous comments on the provisions in the 1988 proposed regulations requiring disaggregation of qualified CODAs with employee stock ownership plans (ESOPs). A number of commentators questioned the requirement in § 1.401(k)-1(b)(5)(ii) of the 1988 final regulations, and § 1.401(m)-1(b)(4)(ii) of the 1988 proposed regulations, that ESOPs be tested separately from other plans. Since an ESOP and a CODA may each be part of a plan, these commentators argued that they may be parts of the same plan and should be allowed to be tested together. The separate testing rule also raised questions concerning the availability of the special CODA nondiscrimination rules to ESOPs.

The final regulations continue to require that the ESOP and the non-ESOP portion of a CODA be tested separately, as provided in the 1988 regulations. After carefully reviewing the relevant provisions of the statute, legislative history, and regulations, the Treasury and the Service continue to believe that Congress did not intend to permit ESOPs and other plans to be aggregated for purposes of the ADP and ACP tests.

Mandatory disaggregation of ESOPs from other plans is consistent with congressional endorsement of the separate testing rule in § 54.4975-11(e)

with respect to the nondiscrimination requirements of the Code, H.R. Rep. No. 1515, 94th Cong., 2d Sess. 541 (1976) (Conference Report); see also H.R. Rep. No. 841, 99th Cong., 2d Sess. II-411 n.1 (1986) (Conference Report). Because mandatory disaggregation has the effect of requiring participation by nonhighly compensated employers in the ESOP, it is also consistent with the longstanding congressional objective of encouraging widespread employee stock ownership through ESOPs, see H.R. Rep. No. 1515, 94th Cong., 2d Sess. 541-42 (1976) (Conference Report); S. Rep. No. 36, 94th Cong., 1st Sess. 58 (1975); see also S. Rep. No. 1263, 95th Cong., 2d Sess. 79 (1978); S. Rep. No. 938, 94th Cong., 2d Sess., Part I, at 180 (1976).

Commentators also argued that mandatory disaggregation of ESOPs is inconsistent with the requirement in section 401(k)(3)(A) and (m)(2)(B) that the ADP and ACP of a highly compensated employee be calculated by aggregating all CODAs or plans in which the employee participates. Aggregation of deferrals and contributions with respect to highly compensated employees participating in both an ESOP and the rest of a plan would, however, generally increase the disparity between the ADP and ACP of highly and nonhighly compensated employees. This is because deferrals and contributions of highly compensated employees under both portions of the plan would be taken into account, whereas only deferrals or contributions under the portion being tested would be taken into account for nonhighly compensated employees.

Commentators suggested that, if mandatory disaggregation were retained, an exception be added to the general aggregation rule for CODAs in which a highly compensated employee participates. In other words, if a highly compensated employee participated in both the ESOP and non-ESOP portion of a CODA, the ADP for the ESOP portion would be calculated by taking into account only the elective contributions and amounts treated as elective contributions under the ESOP portion of the CODA. The ADP for the non-ESOP portion would be calculated by taking into account only the elective contributions and amounts treated as elective contributions under the non-ESOP portion of the CODA. In both cases, the total compensation taken into account under both portions of the CODA would be used in calculating the ADP. The regulations adopt this suggestion. The regulations do not require aggregation in this limited case because the legislative history of section

401(k)(3)(B) and (m)(2)(B) does not suggest that Congress intended a marked departure from past practice in providing these aggregation rules.

Some practitioners have asked whether the separate testing rule for the ESOP and non-ESOP portions of a plan subject to section 401(k) or (m) permits multiple use of the 200 percent/two percentage point alternative method of satisfying the ADP and ACP tests. Under this approach, the multiple use limitation of section 401(m)(9) would first be applied to elective, employee, and matching contributions under the ESOP portions of the plans in which highly compensated individuals participated. It would then be applied separately to the non-ESOP portions of those plans. The final regulations clarify that the multiple use limitation, like the ADP and ACP tests, is applied separately to the ESOP and non-ESOP portions of the plans.

The final regulations do not address a number of significant issues that may affect ESOPs that include elective deferrals, employee contributions, or matching contributions. For example, they do not address issues relating to the treatment of dividends described in section 404(k) for purposes of section 401(k) and (m). The Treasury and the Service have opened a regulations project relating to the interaction of sections 404(k) and 401(k) and (m) and intend to address these issues in the near future. Other ESOP nondiscrimination issues will also be addressed in future regulations. No inference should be drawn from the fact that an issue is not addressed in this document or from the fact that only certain aspects of an issue are addressed.

b. Plans Maintained by More Than One Employer and Collectively Bargained Plans

The treatment of multiemployer and multiple employer plans under section 401(k) and (m) has been clarified in §§ 1.401(k)-1(b)(3)(ii)(B) and (iv) and 1.401(m)-1(b)(3)(ii). Under the final regulations, the ACP test applies to a collectively bargained plan to which section 413(b) applies as if all participants were employed by a single employer. The ADP and ACP tests apply to a plan maintained by more than one employer to which section 413(c) applies as if each employer maintained a separate plan.

Some commentators have questioned whether the ADP and ACP tests must be satisfied by collectively bargained plans. Proposed Reg. § 1.401(a)(4)-1(c)(6) provides that a collectively bargained plan (or portion of a plan) automatically

satisfies the nondiscrimination requirements of section 401(a)(4). Similarly Proposed Reg. § 1.410(b)-6(e) provides that a collectively bargained plan (or portion of a plan) automatically satisfies the coverage requirements of section 410(b). Some commentators have suggested that, since the ADP and ACP tests are special tests for nondiscrimination in contributions or benefits, a collectively bargained plan (or portion of a plan) should not be required to satisfy the ADP and ACP tests.

The final regulations clarify that a collectively bargained plan (or portion of a plan) need not satisfy the ADP or ACP test to be nondiscriminatory. However, the ADP test is part of the definition of a qualified CODA. See section 401(k)(3)(A). An elective contribution by an employee under a nonqualified CODA is includible in the employee's gross income. Sections 1.401(k)-1(a)(5)(iii) and 1.402(a)-1(d). Therefore, while a CODA that is part of a collectively bargained plan and that does not satisfy the ADP test is treated as nondiscriminatory for purposes of section 401(a)(4), the elective contributions under the arrangement are includible in the employees' gross incomes, since the CODA is not a qualified CODA.

The final regulations make prospective the income inclusion of elective contributions under a nonqualified CODA that is part of a collectively bargained plan, provided it satisfies the requirements of section 401(k) other than the ADP test. Thus, for plan years beginning before January 1, 1993, these CODAs are treated as qualified CODAs for purposes of determining whether the elective contributions are includible in gross income. Sections 1.401(k)-1(a)(7) and 1.402(a)-1(d)(3)(iv). This means that elective contributions under the collectively bargained CODA may be excluded from employees' gross incomes even though the plan fails the ADP test for plan years beginning before January 1, 1993. However, for taxable years after 1986 the section 402(g) dollar limit on the exclusion of elective deferrals applies as it would to a qualified CODA.

c. Definition of Plan and Plan Aggregation

The 1988 proposed and final regulations included rules governing which arrangements may be aggregated for purposes of section 401(k) and (m). These rules generally required consistency with the aggregation of plans for purposes of sections 401(a)(4) and 410(b). Thus, all CODAs in a group

of plans treated as a single plan for purposes of sections 401(a)(4) and 410(b) were required to be treated as a single arrangement for purposes of section 401(k), and the plans were required to be aggregated for purposes of section 401(m). Conversely, if two plans were not aggregated for purposes of sections 401(a)(4) and 410(b), they were required to be treated separately under section 401(k) and (m). The 1988 regulations also provided that contributions and allocations under an ESOP could not be combined with any other contributions and allocations for purposes of applying sections 401(a)(4), (k), (m), or 410(b). Also, for plan years beginning after December 31, 1989, plans could be aggregated only if they had the same plan year.

On May 18, 1989, proposed regulations under section 410(b) were published in the *Federal Register* (54 FR 21437). Section 1.410(b)-7 of these proposed regulations defined "plan" and provided rules governing plan aggregation and disaggregation. In addition to requiring the disaggregation of ESOPs from other contributions and allocations, the proposed regulations required disaggregation of plans (or portions of a plan) benefiting collective bargaining unit employees from other plans (or portions of the same plan), plans including qualified CODAs, plans including employee or matching contributions, certain plans benefiting otherwise excludable employees, plans of separate lines of business, and certain plans maintained by more than one employer.

On May 14, 1990, and September 14, 1990, the Treasury and the Service published comprehensive proposed nondiscrimination regulations for qualified plans under sections 401(a)(4) and 410(b) (55 FR 19897 and 55 FR 37888). These proposals supplemented the regulations proposed on May 18, 1989, to provide a coordinated set of nondiscrimination rules for qualified plans. The intent of the regulations published under sections 401(a)(4) and 410(b) was that the principles they enunciated would apply as well to section 401(k) and (m). Accordingly, these final regulations include definitions of a number of terms that are in most respects identical to the rules previously proposed under section 410(b).

The final regulations clarify that, consistent with the requirements of sections 401(a)(4) and 410(b) and the regulations thereunder, the requirements of section 401(k) and (m) are applied separately to separate plans as defined under section 414(l), taking into account

the mandatory disaggregation and permissive aggregation rules under section 410(b). (However, the portion of a plan that includes elective contributions, and the portion of the plan that includes employee and matching contributions need not be disaggregated for purposes of these regulations.) No inference should be drawn from the definition of the term "plan" contained in these regulations concerning how this term may be defined in final regulations under section 410(b). It is anticipated, however, that when final regulations are issued under section 410(b), these regulations will be revised to cross-refer to definitions of common applicability under sections 410(b), 401(k), and 401(m).

d. Restructuring

Section 1.401(a)(4)-9 of the regulations proposed on May 14, 1990, permitted plans to be restructured into component plans that separately satisfy sections 401(a)(4) and 410(b). These rules were intended to permit employers to provide benefits under one plan that otherwise could be provided only under multiple plans. Section 1.401(a)(4)-9, as proposed on May 14, 1990, provided that plans subject to section 401(k) or (m) could be restructured on the basis of employee groups, but could not use the total rate or rate segment methods of restructuring. The preamble to the regulations proposed on September 14, 1990, announced that more objective limits on restructuring plans subject to section 401(k) or (m) were being considered, and requested comments on possible limitations. The preamble stated that pending publication of future regulations, plans subject to section 401(k) or (m) could be restructured on the basis of employee groups as provided in the proposed regulations. Examples were provided of situations where employees shared the requisite common attributes to allow them to be treated as employee groups for purposes of restructuring.

After considering comments received on appropriate restructuring rules for plans subject to sections 401(k) and (m), the Treasury and the Service have concluded that it is inappropriate for these plans to use restructuring. The statutory language of sections 401(k) and (m) indicates that the ADP and ACP tests are to be applied, and appropriate corrections are to be made, on a plan-wide basis. In addition, restructuring dilutes employer incentives to encourage participation by nonhighly compensated employees, and may increase the individual disparities in deferrals and contributions that would

otherwise be permitted under the ADP and ACP tests. For these reasons, the use of restructuring to satisfy sections 401(k) and (m) is not permitted for plan years beginning after December 31, 1991. For plan years beginning before January 1, 1992, plans subject to sections 401(k) and (m) may be restructured on the basis of employee groups as permitted under the regulations proposed on May 14, 1990, as further explained in the preamble to the regulations proposed on September 14, 1990.

4. Distributions

The distribution provisions in the 1988 regulations were largely organized on the basis of the effective dates applicable to various types of distributions. In order to simplify the regulations, these provisions have been substantially reorganized in the final regulations to consolidate all provisions dealing with a particular type of distribution, such as distributions upon plan termination. The reorganization is intended to simplify the regulations, not to change their substance. Changes in the provisions that apply to various types of distributions are described in the following paragraphs.

a. Distributions Upon Plan Termination

Tax Reform Act of 1986 amended section 401(k)(2)(B)(i)(II) to permit distributions from a qualified CODA after the termination of the plan without establishment of a successor plan, effective for plan years beginning after December 31, 1984. The 1988 proposed regulations (§ 1.401(k)-1(d)(1)(ii)(B) and (iii)(B)) defined a successor plan as any other defined contribution plan (other than an ESOP) maintained or established by the employer at the time the plan including the CODA was terminated or within 12 months after distribution of all assets from the CODA. Under the 1988 proposed regulations, if a successor plan existed, the CODA making the distribution did not satisfy section 401(k) and the successor plan was disqualified.

A number of commentators criticized the definition of the term "successor plan" in the 1988 proposed regulations as overbroad. They observed that problems could arise where employers merged, since a plan of a previously unrelated employer could then become a successor plan even though it covered none of the same employees. Similarly, a plan of another member of the employer's controlled group in a different business could be a successor plan and prevent the distribution of benefits upon termination of the plan containing the qualified CODA. Some

commentators suggested solving these problems by providing that a defined contribution plan is not a successor of a plan (including a CODA) if there is no overlap in the eligible employees under the two plans. Many argued that only a plan including a CODA should be a successor plan. Commentators also criticized disqualifying the successor plan under section 401(k) even though the plan might not be subject to that section.

Section 1011(k)(1)(B) of TAMRA enacted Code section 401(k)(10)(A)(i), replacing section 401(k)(2)(B)(i)(II). This codified the definition of a successor plan as any other defined contribution plan (other than an employee stock ownership plan) established or maintained by the employer. As a result, the final regulations could not limit the definition of a successor plan to a plan including a CODA.

In response to comments, the final regulations narrow the definition of a successor plan in several respects, however. First, § 1.401(k)-1(d)(3) of the final regulations provides that if fewer than two percent of the employees who are eligible under the plan that includes the CODA at the time of its termination are eligible under another plan at any time during the 24 months beginning 12 months before the time of the termination, the other plan is not a successor plan. For example, if an employer maintains a plan including a CODA and another defined contribution plan for two distinct groups of employees, and there is no overlap in the employees eligible under the plans, the other defined contribution plan is not a successor plan. Second, the final regulations clarify that a simplified employee pension, as defined in section 408(k), is not a successor plan. Finally, the successor plan is not disqualified by an impermissible distribution from a CODA on plan termination.

b. Hardship Distributions

Many commentators praised the 1988 final regulations for providing safe harbors to determine the existence of an immediate and heavy financial need (§ 1.401(k)-1(d)(2)(ii)(B)) and the necessity of a distribution to satisfy the financial need (§ 1.401(k)-1(d)(2)(iii)(B)). Some, however, requested liberalization or clarification of specific aspects of the deemed hardship rules. Many of their suggestions are reflected in the final regulations.

For example, several commentators stated that the provision in the 1988 final regulations (§ 1.401(k)-1(d)(2)(ii)(B)(3)) permitting a hardship distribution for the payment of tuition only for the next semester or quarter was unduly

burdensome for employees and plan administrators since it required multiple distributions to cover what amounts to a single hardship. Accordingly, the limitation to payment for the next semester or quarter has been dropped. The final regulations permit a distribution on account of tuition and related educational fees for the next 12 months of post-secondary education.

Clarification of the requirement that medical expenses be "incurred" to be deemed an immediate and heavy financial need was also requested. In response, the safe harbor was modified to allow distribution of amounts necessary for the employee, the employee's spouse, or the employee's dependent to obtain medical services. Unless this standard is met, however, the expenses must be incurred before the deemed hardship distribution is made.

The safe harbor was also modified to clarify that the amount that may be distributed on account of a hardship includes the amount necessary to pay income taxes or penalties resulting from the distribution. Thus, the amount to be distributed for the financial need may be "grossed up" for anticipated federal and state income taxes and penalties.

Several commentators stated that the requirement (one of the conditions for deeming a distribution necessary to satisfy a financial need) that a participant obtain the maximum loan available before taking a hardship distribution could cause less than the participant's entire account balance to be available for alleviating the hardship. This concern stemmed from the requirement in the Department of Labor regulations, at 29 CFR 2550.408b-1(f), that a plan making a participant loan must obtain security of sufficient value that it may be reasonably anticipated that loss of principal or interest will not result from the loan. The commentators believed that this might require that an amount exceeding the amount borrowed serve as security for the loan. This would effectively reduce the amount available to the participant.

This is not necessarily the case. The Department of Labor has informed the Treasury and the Service that, if a plan provides an individual account for each participant, and the investment experience of the assets in that account is allocated solely to that account, any participant who has a vested accrued benefit may borrow up to 50 percent of the present value of the accrued benefit secured by that same 50 percent of the vested account balance. For example, in this type of plan a participant with a vested accrued benefit with a present value of \$10,000 may borrow \$5,000,

secured by 50 percent of the vested account balance, *i.e.*, \$5,000, and meet the terms of the Department of Labor regulations at 29 CFR 2550.408b-1(f) (1) and (2). The remaining \$5,000 is available for a hardship distribution. See 54 FR 30526. Accordingly, no change has been made in these regulations with respect to the loan requirement.

Section 1.401(k)-1(d)(2)(iv)(A) of the 1988 final regulations provided that a plan does not violate section 411(d)(6) merely because it was amended to modify the standards for hardship distributions to reflect the applicable requirements of the regulations. The 1988 final regulations limited this exception to section 411(d)(6) to amendments effective on or before the first day of the first plan year commencing on or after January 1, 1989. Notice 88-127, 1988-2 C.B. 538, provided that the exception to section 411(d)(6) applied to an amendment adopted within the time period permitted for required amendments to the plan under section 1140 of TRA '86, as extended in the regulations under section 401(b), that was retroactively effective to the date on which the plan began operating in accordance with the standards. Commentators argued that a permanent exception to section 411(d)(6) was needed to enable a plan to adapt to changing needs of employees and employers, changing economic circumstances, and their experience in administering provisions. In response to commentators' suggestions, § 1.411(d)-4, A-2(b)(2), of the regulations has been amended to permit a plan amendment to specify or modify nondiscriminatory and objective standards for determining the existence of an immediate and heavy financial need, the amount necessary to meet the need, or other conditions relating to eligibility to receive a hardship distribution. For example, a plan using the general rules for hardship distributions could replace them with the deeming rules, or could alter (whether to restrict or to relax) its standards for applying the general rules. These changes may be made at any time without violating section 411(d)(6). A plan may also be amended to eliminate hardship distributions.

Many comments suggested additional circumstances that could give rise to a deemed immediate and heavy financial need. In general, the circumstances described depended so heavily on facts and circumstances that they could not be delineated precisely in the list of circumstances qualifying for the safe harbors. In addition, an employer that wishes to allow distributions in circumstances not listed in the deeming

provision may permit distributions under the general hardship rules, by including appropriate language in the plan. The Treasury and the Service therefore decided not to expand the list of deemed immediate heavy and financial needs.

Section 1.401(k)-1(d)(2)(iii)(B)(3) of the 1988 final regulations provided that one of the conditions for deeming a hardship distribution necessary to satisfy a financial need is that the employee's elective contributions and employee contributions to the plan and all other plans maintained by the employer be suspended for at least 12 months after receipt of the hardship distribution. Several commentators asked how the Service would interpret the phrase "all other plans of the employer" and requested that the Service clarify the types of plans from which an employee's participation must be suspended after a hardship distribution.

Notice 88-127, 1988-2 C.B. 538, responded to these questions by clarifying that the phrase includes all qualified and nonqualified plans of deferred compensation maintained by the employer, other than the mandatory employee contribution portion of a defined benefit plan. Stock option, stock purchase, and similar plans, as well as a CODA that is part of a cafeteria plan (but not the cafeteria plan itself) are also included in the definition. Health and welfare benefit plans are not included. Several commentators argued that this definition was overbroad, and should not include nonqualified plans. The reason for requiring suspension, however, is that a participant who can continue to defer funds under any type of plan shows evidence of having funds that can be used to meet the financial burden. Since the employer is able to control the participant's access to nonqualified as well as qualified plans, the Treasury and the Service concluded that, to be consistent, the suspension must apply to all these plans. The final regulations therefore incorporate the definition from Notice 88-127.

A number of commentators asked whether it was necessary to amend an employer's plans (other than the one including the CODA) that could be affected by the required suspension of contributions in order to implement the suspension. Section 1.401(k)-1(d)(2)(iii)(B)(3) of the 1988 final regulations required that all of these plans provide for the suspension. This requirement has been relaxed in the final regulations, which require only that the employee be prohibited under a legally enforceable arrangement from making elective or employee

contributions under the plan and all other plans maintained by the employer for at least 12 months after the hardship distribution. A legally enforceable arrangement might, for example, consist of the employee's written agreement not to make or elect contributions under any plan of the employer for the requisite period, or provisions in all of the affected plans.

c. Default on Loan as Distribution

Section 1.401(k)-1(d)(4) of the 1988 final regulations provided that a reduction of an employee's accrued benefit derived from elective contributions because of a default on a plan loan was a distribution. Thus, under this rule a CODA was disqualified if it permitted a reduction of the accrued benefit before one of the permitted distribution events listed in section 401(k)(2)(B). Commentators correctly observed that this fact could have made plan loans secured solely by a participant's accrued benefit impossible, for proposed Department of Labor regulations treated a participant's vested accrued benefit under a plan as adequately securing a loan only if it could be used to satisfy a participant's outstanding obligation in the event of default.

Since the 1988 final regulations were issued, the Department of Labor has issued final regulations requiring that loans to participants be adequately secured to come within the statutory exemption provided by section 408(b)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) and Code section 4975(d)(1). 29 CFR 2550.408b-1. This requirement must be satisfied immediately after the loan is made. 29 CFR 2550.408b-1(f)(2). The Department of Labor regulations provide that up to 50 percent of the present value of a participant's vested accrued benefit may be considered by a plan as security for the outstanding balance on all plan loans to that participant. Thus, where the investment experience on a plan loan is allocated to the borrower's account, a loan of up to 50 percent of the present value of the participant's vested accrued benefit will satisfy the adequate security requirement even if the plan (in compliance with § 1.401(k)-1(d)(6)(i)) may not reduce the participant's account balance upon default until a permitted distribution event occurred.

Most plans do not permit loans of more than 50 percent of the participant's vested accrued benefit, except loans of \$10,000 or less, in order to avoid taxation of loans as distributions under section 72(p). With respect to all loans, including those of \$10,000 or less secured by a participant's vested

accrued benefit, the Department of Labor regulations govern for purposes of determining whether a loan comes within the statutory exemption provided by ERISA section 408(b)(1) and Code section 4975(d)(1). Therefore, the final Department of Labor regulations eliminate the conflict feared by the commentators. Accordingly, the final section 402(k) regulations retain the provision that reduction of an employee's accrued benefit upon a loan default is a distribution. It should be noted that only an actual reduction of the accrued benefit upon default is a distribution for this purpose. As provided in § 1.401(k)-1(d)(6)(ii), the amount of a loan is not a distribution for this purpose even if it is includible in the employee's gross income under section 72(p) (for example, if it is not payable within five years).

5. Other Benefits Not Contingent Upon Elective Deferrals

Section 401(k)(4)(A) and § 1.401(k)-1(e)(6) of the 1988 proposed regulations provide that a CODA does not meet the requirements of section 401(k) if any other benefit (other than a matching contribution described in section 401(m)) is contingent upon the employee's elective deferrals. The 1988 proposed regulations define other benefits as including benefits under various types of nonqualified plans, such as nonqualified deferred compensation plans. Several commentators criticized this aspect of the definition as overbroad. The statutory language, however, is not limited to qualified plans.

The final regulations clarify the definition in two ways suggested by commentators. First, they provide that participation in a nonqualified deferred compensation plan is contingent upon an employee's elective deferrals to the extent that an employee may receive additional deferred compensation under it if the employee makes or does not make elective contributions. For example, an arrangement that allows an employee to defer up to 10 percent of compensation, and to choose between deferring it under a CODA or under a nonqualified deferred compensation plan violates the contingent benefit rule since the maximum deferral under the nonqualified plan depends on the employee's elective deferrals under the CODA. Second, these final regulations clarify that deferred compensation under a nonqualified plan that is dependent on an employee's having made the maximum elective deferrals under section 402(g), the maximum elective contributions under section

401(k)(3), or the maximum elective contributions permitted under the terms of the plan does not violate the contingent benefit rule. Section 1.401(k)-1(e)(6)(iv).

6. Determination of Excess Contributions and Excess Aggregate Contributions.

Section 1.401(k)-1(f)(2) of the 1988 final regulations required the amount of excess contributions (those exceeding the amount permitted by the ADP test) for a highly compensated employee to be determined by a leveling method. Under this method the highest ADP of any highly compensated employee was reduced until either the CODA satisfied the ADP test or the highest ADP of any highly compensated employee was reduced to equal the next highest ADP of any highly compensated employee. This process had to be repeated until the CODA satisfied the ADP test. Proposed Reg. § 1.401(m)-1(e)(2) prescribed an analogous leveling method for determining the amount of excess aggregate contributions (those exceeding the amount permitted by the ACP test).

Several commentators have suggested that the regulations not limit the method used by a plan to determine the amount of excess contributions or excess aggregate contributions of a highly compensated employee. They have observed that, since only highly compensated employees can have excess contributions or excess aggregate contributions, no method could discriminate against the nonhighly compensated employees. Moreover, the leveling method used in the 1988 proposed and final regulations could favor the more highly compensated among the highly compensated employees. This is true because many highly compensated employees make elective deferrals equal to the section 402(g) limit, which is a larger percentage of compensation for a less highly compensated employee. For example, assume that under a calendar year plan two highly compensated employees, with 1991 compensation of \$75,000 and \$200,000, respectively, elect the maximum elective deferrals of \$8,475 each for 1991. If there are no qualified nonelective contributions or qualified matching contributions, the ADP of the \$75,000 employee is \$8,475/\$75,000, or 11.30 percent, while the ADP of the \$200,000 employee is \$8,475/\$200,000, or 4.24 percent. If there were excess contributions for 1991, the leveling method in the 1988 proposed and final regulations would require a larger amount of the \$75,000 employee's elective deferrals to be distributed or

recharacterized, since it required the plan to allocate excess contributions first to the highly paid employee with the highest ADP.

The leveling method in the 1988 proposed and final regulations is compelled by the statute. Section 401(k)(8)(B)(ii), defining "excess contributions," provides that they must be "determined by reducing contributions made on behalf of highly compensated employees in order of the actual deferral percentages beginning with the highest of such percentages." Section 401(m)(6)(B)(ii) uses analogous language in defining "excess aggregate contributions." The House Ways and Means Committee Report on the Tax Reform Act of 1986 includes an example of this leveling method that implies that it is the exclusive method. See H.R. Rep. No. 426, 99th Cong., 1st Sess. 691-92 (1985); see also H.R. Rep. No. 841, 99th Cong., 2d Sess. II-383, 388 (1986) (Conference Report).

Accordingly, the leveling method in the regulations has not been modified, and remains the exclusive method for plans to use in determining excess contributions or excess aggregate contributions. The leveling method is required, however, only where excess contributions or excess aggregate contributions have been made and are to be distributed, recharacterized, or forfeited. A plan may use a different method to adjust participant elections before contributions are made to prevent excess contributions or excess aggregate contributions from occurring.

7. Allocation of Income to Excess Contributions, Excess Aggregate Contributions, and Excess Deferrals

The 1988 proposed regulations (§§ 1.401(k)-1(f)(4)(ii), 1.401(m)-1(e)(3)(ii), and 1.402(g)-1(d)(5)) prescribed a specific method for allocating income to excess contributions, excess aggregate contributions, and excess deferrals that were distributed or recharacterized. That method allocated income in proportion to the ratio of the excess amounts to the relevant portion of the employee's account balance as of the end of the plan year (without regard to gain or loss during the plan year). For example, under that method the income allocable to excess contributions for a plan year was determined by multiplying the income allocable to elective contributions and amounts treated as elective contributions by the ratio of the excess contributions to the employee's account balance as of the end of the plan year attributable to elective contributions and amounts treated as elective contributions,

reduced by gain and increased by loss allocable to the total amount during the plan year.

Many commentators considered the method too restrictive, since plans often allocate income to participants' accounts more precisely. They also said that the 1988 proposed regulations' method was not consistent with normal plan accounting and therefore imposed an unnecessary administrative burden on plans, which were effectively forced to calculate the allocable income twice, first in their normal manner, and then in the manner prescribed by the 1988 proposed regulations.

In addition to the methods described in the proposed regulations, the final regulations permit plans to use any reasonable method they otherwise use for allocating income to participants' accounts. As suggested by commentators, final regulations also simplify the allocation of income by making it permissive, rather than mandatory, to allocate income for the gap period (the period from the end of the plan year to the date of distribution).

8. Period for Determining Compensation

Sections 1.401(k)-1(g)(9)(ii) and 1.401(m)-1(f)(14) of the 1988 proposed regulations provided in general that a plan must take into account all compensation of a participant for the plan year for purposes of the ADP and ACP tests, even if the employee was eligible to participate in the CODA, to make employee contributions, or to have matching contributions made to the employee's account for only part of the plan year. Section VI of Notice 88-127, 1988-2 C.B. 538, stated that final regulations would be amended to allow a plan to limit compensation taken into account to compensation received by an employee while the employee was a participant, for plan years beginning before January 1, 1990. Rev. Proc. 89-65, 1989-2 C.B. 786, extended this temporary rule to allow a plan to limit compensation to the amount received while the employee was a participant for plan years beginning before the later of January 1, 1992, or the date that is 60 days after publication of final regulations.

A number of commentators suggested that this temporary rule be made permanent because, in the case of defined contribution plans, it is consistent with the principle of nondiscrimination to measure compensation by reference to the portion of the plan year during which an employee is a plan participant. The Treasury and the Service agree. On September 14, 1990, proposed regulation

§ 1.401(a)(4)-2(f) was revised to allow plans to take into account for discrimination testing only compensation received by the employee while a plan participant. The final regulations apply this principle to section 401 (k) and (m) by providing that compensation may be determined for the same period described in Proposed Reg. § 1.401(a)(4)-2(f). Thus, a plan may provide that the ADP or ACP test is applied using the compensation received by an employee while eligible to participate in the CODA, to make employee contributions, or to have matching contributions made on the employee's behalf. Alternatively, a plan may calculate compensation for a plan year based on the calendar year ending within the plan year.

9. Effective Date for Applying the Actual Deferral Percentage and Actual Contribution Percentage Tests to Governmental Plans

Section 1.401(m)-1(g)(4) of the final regulations provides that the ACP test does not apply to governmental plans described in section 414(d) for plan years beginning before January 1, 1993. For the same period, § 1.401(k)-1(h)(4)(ii) provides that a governmental plan need not satisfy the ADP test to be considered nondiscriminatory. The modified effective date is the same as the end of the transition rule provided for governmental plans for applying the general nondiscrimination rules (Proposed Reg. § 1.401(a)(4)-13(b)).

Although elective contributions may be excluded from gross income only if made under a qualified CODA, CODAs under governmental plans will be treated as qualified CODAs during this transition period even though the plan fails the ADP test. However, for taxable years beginning after December 31, 1986, the dollar limit on the exclusion of elective deferrals applies as it would to a qualified CODA. Of course, the transitional relief applies only to a governmental unit that adopted a CODA before May 7, 1986, and is therefore permitted to maintain one. See section 401(k)(4)(B) and § 1.401(k)-1(e)(4) of the final regulations.

10. Correction of Excess Annual Additions Under Section 415

Many commentators have asked how excess annual additions under section 415(c) may be corrected if they consist of elective contributions. In response to their suggestions, § 1.415-6(b)(6) of the regulations has been amended to provide a simple method of correcting elective contributions that (in combination with other contributions) exceed the limits of section 415. As

amended, the regulations allow plans to distribute elective contributions to correct excess annual additions resulting from a reasonable error in determining the amount of elective deferrals that a participant may make under the limits of section 415.

11. Reduction of Excess Accrued Benefits Under a Defined Benefit Plan

Section 1106 of TRA '86 revised the method of computing the limitations of section 415 for defined benefit plans. Although section 1106(i)(1) provides that the amendments to section 415 are generally effective for limitation years beginning after December 31, 1986, section 1106(i)(3) protects the "current accrued benefit" for any individual who was a participant in a defined benefit plan as of the first day of the first TRA '86 limitation year, provided the plan existed on May 6, 1986, and satisfied the applicable section 415 limits for all pre-TRA '86 limitation years. The protected accrued benefit is the participant's accrued benefit as of the last pre-TRA '86 limitation year determined without regard to changes in the terms and conditions of the plan or cost-of-living increases occurring after May 5, 1986.

Q&A 13 of Notice 87-21, 1987-1 C.B. 458, acknowledged that accrued benefits on the first day of the first TRA '86 limitation year might exceed the 415 limits because of the changes in the terms or conditions of the plan or the establishment of a plan after May 5, 1986. The Notice announced that "future regulations will provide that such plans will be allowed to reduce such excess accrued benefits to the level permitted under TRA '86 without violating section 411(d)(6) of the Code." Section 1.411(d)-4, A-2(b)(2) is amended to permit reduction of the excess accrued benefits to the section 415(b) limit.

Other Actions Taken

Other changes in style and organization have been made in order to improve, clarify, and resolve areas that commentators noted as being ambiguous.

Effective Dates

These regulations are generally effective for plan years beginning after December 31, 1979. Those portions of the regulations relating to amendments made by the Tax Reform Act of 1986 are generally effective for years beginning after December 31, 1986. There are special effective date rules for plans maintained pursuant to collective bargaining agreements. In addition, portions of these regulations become applicable to various taxpayers and

plans as of dates other than the general effective date.

For plan years beginning after December 31, 1987, and before January 1, 1992, a plan may rely on a reasonable interpretation of the rules set forth in section 401 (k) and (m) (as in effect during those years) to determine whether a plan or a CODA was qualified during those years. For those years, operation in accordance with the proposed and final regulations published in the *Federal Register* on August 8, 1988, 53 FR 29658 and 29719, as amended on May 14, 1990 (55 FR 19897), is a reasonable interpretation of those sections.

For plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1988, a reasonable interpretation of the rules set forth in section 401 (k) and (m) (as in effect during those years) may be relied upon to determine whether a plan or a CODA was qualified during those years. For those years, and with respect to hardship distributions made before April 1, 1989, operation in accordance with the proposed regulations published in the *Federal Register* on November 10, 1981, 46 FR 55544, is a reasonable interpretation of those sections.

Plan Amendments

Plan sponsors may defer amendments required by these regulations until the earlier of plan termination or the last date for making amendments provided by section 1140 of the Tax Reform Act of 1986, as extended in the regulations under section 401(b). The Commissioner has extended the remedial amendment period for making amendments required by the Tax Reform Act of 1986 until the last day of the first plan year beginning after December 31, 1991. To be eligible for this extended remedial amendment period, a plan must be operated in accordance with the regulations beginning on their applicable effective dates with respect to the plan. Rev. Proc. 89-65, 1989-2 C.B. 786 (section 3), as modified by Notice 90-73, 1990-2 C.B. 353 (section III).

Amendments may be made until the later of the end of this extended remedial amendment period, or the date the remedial amendment period would have ended if it had not been extended. In general, the remedial amendment period would end on the last date prescribed by law, including extensions, for filing the income tax return of the employer for the employer's taxable year in which the date of the remedial amendment period begins. If a

determination letter is requested during the remedial amendment period, the required plan amendments must be adopted no later than ninety days after receipt of a favorable determination letter.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the proposed regulations published after November 20, 1988, were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Catherine Livingston Fernandez of the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Treasury and the Service participated in their development.

List of Subjects

26 CFR Part 1 (1.401-0—1.419A-2T)

Bonds, Employee Benefit Plans, Income Taxes, Pensions, Reporting and recordkeeping requirements, Securities, Trusts and trustees.

26 CFR Part 54

Excise taxes, Pensions, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 54, and 602 are amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 continues to read in part:

Authority: 26 U.S.C. 7805 * * *.

Paragraph 2. Section 1.401(a)-30 is added to read as follows:

§ 1.401(a)-30 Limit on elective deferrals.

(a) *General Rule.* A trust that is part of a plan under which elective deferrals may be made during a calendar year is not qualified under section 401(a) unless the plan provides that the elective deferrals on behalf of an individual under the plan and all other plans, contracts, or arrangements of the employer maintaining the plan may not exceed the applicable limit for the individual's taxable year beginning in the calendar year. A plan may incorporate the applicable limit by reference. In the case of a plan maintained by more than one employer to which section 413 (b) or (c) applies, section 401(a)(30) and this section are applied as if each employer maintained a separate plan. See § 1.402(g)-1(e) for rules permitting the distribution of excess deferrals to prevent disqualification of a plan or trust for failure to comply in operation with section 401(a)(30).

(b) *Definitions.* For purposes of this section:

(1) *Applicable limit.* The term "applicable limit" has the meaning provided in § 1.402(g)-1(d).

(2) *Elective deferrals.* The term "elective deferrals" has the meaning provided in § 1.402(g)-1(b).

(c) *Effective date.*—(1) *In general.* Except as otherwise provided in this paragraph (c), this section is effective for plan years beginning after December 31, 1987.

(2) *Transition rule.* For plan years beginning in 1988, a plan may rely on a reasonable interpretation of the law as in effect on December 31, 1987.

(3) *Deferrals under collective bargaining agreements.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, this section does not apply to contributions made pursuant to a collective bargaining agreement for plan years beginning before the earlier of:

(i) The later of January 1, 1988, or the date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after February 28, 1986), or

(ii) January 1, 1989.

Paragraph 3. Sections 1.401(k)-0 and 1.401(k)-1 are revised to read as follow:

§ 1.401(k)-0 Certain cash or deferred arrangements, table of contents.

This section contains the captions that appear in § 1.401(k)-1.

§ 1.401(k)-1 Certain cash or deferred arrangements.

(a) General rules.

(1) Certain plans permitted to include cash or deferred arrangements.

(2) Rules applicable to cash or deferred arrangements generally.

(i) Definition of cash or deferred arrangement.

(ii) Treatment of after-tax employee contributions.

(iii) Treatment of elective contributions as plan assets.

(3) Rules applicable to cash or deferred elections generally.

(i) Definition of cash or deferred election.

(ii) Requirement that amounts not be currently available.

(iii) Amounts currently available.

(iv) Certain one-time elections not treated as cash or deferred elections.

(v) Tax treatment of employees.

(vi) Examples.

(4) Rules applicable to qualified cash or deferred arrangements.

(i) Definition of qualified cash or deferred arrangement.

(ii) Treatment of elective contributions as employer contributions.

(iii) Tax treatment of employees.

(iv) Application of nondiscrimination requirements to plan that includes a qualified cash or deferred arrangement.

(5) Rules applicable to nonqualified cash or deferred arrangements.

(i) Definition of nonqualified cash or deferred arrangement.

(ii) Treatment of elective contributions as employer contributions.

(iii) Tax treatment of employees.

(iv) Qualification of plan that includes a nonqualified cash or deferred arrangement.

(6) Rules applicable to partnership cash or deferred arrangements.

(i) Application of general rules.

(ii) Definition of partnership cash or deferred arrangement.

(A) General rule.

(B) Timing of partner's cash or deferred election.

(C) Transition rule for partnership cash or deferred elections.

(iii) Treatment of certain matching contributions as elective contributions.

(7) Rules applicable to collectively bargained plans.

(i) In general.

(ii) Example

(b) Coverage and nondiscrimination requirements.

(1) In general.

(2) Actual deferral percentage test.

(i) General rule.

(ii) Rule for plan years beginning after 1979 and before 1987.

(iii) Plan provision requirement.

(3) Aggregation of arrangements and plans.

(i) Aggregation of arrangements under plan.

(ii) Aggregation of plans.

(A) General rule.

(B) Prohibited aggregation.

(iii) Restructuring.

(iv) Collectively bargained plans.

- (4) Elective contributions taken into account under the actual deferral percentage test.
 - (i) General rule.
 - (ii) Elective contributions used to satisfy actual contribution percentage test.
 - (iii) Elective contributions for partners.
 - (iv) Elective contributions not taken into account.
 - (5) Qualified nonelective contributions and qualified matching contributions that may be taken into account under the actual deferral percentage test.
 - (6) Examples.
 - (c) Nonforfeiture requirement.
 - (1) General rule.
 - (2) Example.
 - (d) Distribution limitation.
 - (1) General rule.
 - (2) Rules applicable to hardship distributions.
 - (i) Distribution must be on account of hardship.
 - (ii) Limit on distributable amount.
 - (iii) General hardship distribution standards.
 - (A) Immediate and heavy financial need.
 - (B) Distribution necessary to satisfy financial need.
 - (iv) Deemed hardship distribution standards.
 - (A) Deemed immediate and heavy financial need.
 - (B) Distribution deemed necessary to satisfy financial need.
 - (C) Commissioner may expand standards.
 - (3) Rules applicable to distributions upon plan termination.
 - (4) Rules applicable to distributions upon sale of assets or subsidiary.
 - (i) Seller must maintain the plan.
 - (ii) Employee must continue employment.
 - (iii) Distribution must be in connection with disposition of assets or subsidiary.
 - (iv) Definitions.
 - (A) Substantially all.
 - (B) Unrelated employer.
 - (5) Lump sum requirement for certain distributions.
 - (6) Rules applicable to all distributions.
 - (i) Impermissible distributions.
 - (ii) Deemed distributions.
 - (iii) ESOP dividend distributions.
 - (iv) Limitations apply after transfer.
 - (v) Required consent.
 - (7) Examples.
 - (e) Additional requirements for qualified cash or deferred arrangements.
 - (1) Qualified profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan requirement.
 - (2) Cash availability requirement.
 - (3) Separate accounting requirement.
 - (i) General rule.
 - (ii) Failure to satisfy separate accounting requirement.
 - (4) Limitations on cash or deferred arrangements of state and local governments and tax-exempt organizations.
 - (5) One-year eligibility requirement.
 - (6) Other benefits not contingent upon elective contributions.
 - (i) General rule.
 - (ii) Definition of other benefits.
 - (iii) Effect of certain statutory limits.
 - (iv) Nonqualified deferred compensation.
 - (v) Plan loans and distributions.
 - (7) Coordination with other plans.
 - (8) Recordkeeping requirements.
 - (f) Correction of excess contributions.
 - (1) General rule.
 - (i) Permissible correction methods.
 - (ii) Combination of correction methods.
 - (iii) Impermissible correction methods.
 - (iv) Partial distributions.
 - (2) Amount of excess contributions.
 - (3) Recharacterization of excess contributions.
 - (i) General rule.
 - (ii) Treatment of recharacterized excess contributions.
 - (iii) Additional rules.
 - (A) Time of recharacterization.
 - (B) Employee contributions must be permitted under plan.
 - (C) Plans under which excess contributions may be recharacterized.
 - (iv) Transition rules.
 - (v) Example.
 - (4) Corrective distribution of excess contributions (and income).
 - (i) General rule.
 - (ii) Income allocable to excess contributions.
 - (A) General rule.
 - (B) Method of allocating income.
 - (C) Alternative method of allocating income.
 - (D) Safe harbor method of allocating gap period income.
 - (iii) No employee or spousal consent required.
 - (iv) Treatment of corrective distributions as employer contributions.
 - (v) Tax treatment of corrective distributions.
 - (A) General rule.
 - (B) Rule for de minimis distributions.
 - (C) Rule for certain 1987 and 1988 excess contributions.
 - (vi) No reduction of required minimum distribution.
 - (5) Rules applicable to all corrections.
 - (i) Coordination with distribution of excess deferrals.
 - (A) In general.
 - (B) Treatment of excess contributions that reduce excess deferrals.
 - (ii) Correction of family members.
 - (iii) Matching contributions forfeited because of excess deferral or contribution.
 - (6) Failure to correct.
 - (i) Failure to correct within 2½ months after end of plan year.
 - (ii) Failure to correct within 12 months after end of plan year.
 - (7) Examples.
 - (g) Definitions.
 - (1) Actual deferral percentage.
 - (i) General rule.
 - (ii) Actual deferral ratio.
 - (A) General rule.
 - (B) Employee eligible under more than one arrangement.
 - (1) Highly compensated employees.
 - (2) Nonhighly compensated employees.
 - (3) Treatment of plans with different plan years.
 - (C) Employees subject to family aggregation rules.
- (1) Aggregation of elective contributions and other amounts.
- (2) Effect on actual deferral percentage of nonhighly compensated employees.
- (3) Multiple family groups.
 - (2) Compensation.
 - (i) Years beginning after December 31, 1986.
 - (ii) Years beginning before January 1, 1987.
 - (A) General rule.
 - (B) Nondiscrimination requirement.
 - (3) Elective contributions.
 - (4) Eligible employee.
 - (i) General rule.
 - (ii) Certain one-time elections.
 - (5) Employee.
 - (6) Employer.
 - (7) Excess contributions and excess deferrals.
 - (i) Excess contributions.
 - (ii) Excess deferrals.
 - (8) Highly compensated employees.
 - (i) Plan years beginning after December 31, 1986.
 - (ii) Plan years beginning after December 31, 1979 and before January 1, 1987.
 - (9) Matching contributions.
 - (10) Nonelective contributions.
 - (11) Plan.
 - (i) General rule.
 - (ii) Separate asset pools are separate plans.
 - (iii) Mandatory disaggregation of certain plans.
 - (A) Plans benefiting collective bargaining unit employees.
 - (B) ESOPs and non-ESOPs.
 - (C) Plans benefiting employees of qualified separate lines of business.
 - (D) Plans maintained by more than one employer.
 - (1) Multiple employer plans.
 - (2) Multiemployer plans.
 - (iv) Mandatory aggregation of certain plans.
 - (12) Pre-ERISA money purchase pension plan.
 - (13) Qualified matching contributions and qualified nonelective contributions.
 - (i) Qualified matching contributions.
 - (ii) Qualified nonelective contributions.
 - (iii) Additional requirements.
 - (14) Rural cooperative plan.
- (h) Effective dates.
 - (1) General rule.
 - (2) Collectively bargained plans.
 - (3) Transition rules.
 - (i) Cash or deferred arrangements in existence on June 27, 1974.
 - (ii) Plan years beginning after December 31, 1979, and before January 1, 1992.
 - (iii) Restructuring.
 - (A) General rule.
 - (B) Identification of component plans.
 - (1) Minimum coverage requirement.
 - (2) Commonality requirement.
 - (4) State and local government plans.
 - (i) Plans adopted before May 6, 1986.
 - (ii) Plan years beginning before January 1, 1993.
 - (iii) Collectively bargained plans.

§ 1.401(k)-1 Certain cash or deferred arrangements.

(a) *General rules*—(1) *Certain plans permitted to include cash or deferred arrangements.* A plan, other than a

profit-sharing, stock bonus, pre-ERISA money purchase pension or rural cooperative plan, does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a cash or deferred arrangement. A cash or deferred arrangement is part of a plan for purposes of this section if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.

(2) *Rules applicable to cash or deferred arrangements generally*—(i) *Definition of cash or deferred arrangement.* Except as provided in paragraph (a)(2)(ii) of this section, a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) (including a contract that is intended to satisfy the requirements of section 403(a)).

(ii) *Treatment of after-tax employee contributions.* A cash or deferred arrangement does not include an arrangement under which amounts contributed under a plan at an employee's election are designated or treated at the time of contribution as after-tax employee contributions (e.g., by reporting the contributions as taxable income subject to applicable withholding requirements). See also section 414(h)(1). This is the case even if the employee's election to make after-tax employee contributions is made before the amounts subject to the election are currently available to the employee.

(iii) *Treatment of elective contributions as plan assets.* The extent to which elective contributions under a cash or deferred arrangement constitute plan assets for purposes of the prohibited transaction provisions of section 4975 of the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974 is determined in accordance with regulations and rulings issued by the Department of Labor.

(3) *Rules applicable to cash or deferred elections generally*—(i) *Definition of cash or deferred election.* A cash or deferred election is any election (or modification of an earlier election) by an employee to have the employee either—

(A) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available, or

(B) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

A cash or deferred election includes a salary reduction agreement between an employee and employer under which a contribution is made under a plan only if the employee elects to reduce cash compensation or to forgo an increase in cash compensation.

(ii) *Requirement that amounts not be currently available.* A cash or deferred election can only be made with respect to an amount that is not currently available to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.

(iii) *Amounts currently available.* Cash or another taxable amount is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable amount at the employee's discretion. An amount is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the amount currently. Similarly, an amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future. The determination of whether an amount is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451.

(iv) *Certain one-time elections not treated as cash or deferred elections.* A cash or deferred election does not include a one-time irrevocable election upon an employee's commencement of employment with the employer or upon the employee's first becoming eligible under any plan of the employer, to have contributions equal to a specified amount or percentage of the employee's compensation (including no amount of compensation) made by the employer on the employee's behalf to the plan and to any other plan of the employer (including plans not yet established) for the duration of the employee's employment with the employer, or in the case of a defined benefit plan to receive accruals or other benefits (including no

benefits) under such plans. Thus, for example, employer contributions pursuant to a one-time irrevocable election described in this paragraph are not treated as having been made pursuant to a cash or deferred election and are not includible in an employee's gross income by reason of § 1.402(a)-1(d). See paragraph (a)(6)(ii)(C) of this section for an additional one-time election permitted under a cash or deferred arrangement in which partners may participate.

(v) *Tax treatment of employees.* An amount generally is includible in an employee's gross income for the taxable year in which the employee actually or constructively receives the amount. But for section 402(a)(8) and section 401(k), an employee is treated as having received an amount that is contributed to a plan pursuant to the employee's cash or deferred election. This is the case even if the election to defer is made before the year in which the amount is earned, or before the amount is currently available. See § 1.402(a)-1(d).

(vi) *Examples.* The provisions of this paragraph (a)(3) are illustrated by the following examples:

Example 1. An employer maintains a profit-sharing plan under which each eligible employee has an election to defer an annual bonus payable on January 30 each year. The bonus equals 10 percent of compensation during the previous calendar year. Deferred amounts are not treated as after-tax employee contributions. The bonus is currently available on January 30. An election made prior to January 30 to defer all or part of the bonus is a cash or deferred election, and the bonus deferral arrangement is a cash or deferred arrangement.

Example 2. An employer maintains a profit-sharing plan under which each eligible employee may elect to defer up to 10 percent of compensation for each payroll period during the plan year. An election to defer compensation for a payroll period is a cash or deferred election if the election is made prior to the date on which the compensation is to be paid to the employee and if the deferred amount is not treated as an after-tax employee contribution at the time of deferral.

(4) *Rules applicable to qualified cash or deferred arrangements*—(i) *Definition of qualified cash or deferred arrangement.* A qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs (b), (c), (d), and (e) of this section and that is part of a plan that otherwise satisfies the requirements of section 401(a).

(ii) *Treatment of elective contributions as employer contributions.* Except as provided in paragraph (f) of this section, elective contributions under a qualified cash or deferred arrangement

are treated as employer contributions. Thus, for example, elective contributions are treated as employer contributions for purposes of sections 401(a) and 401(k), 402(a), 404, 409, 411, 412, 415, 416, and 417.

(iii) *Tax treatment of employees.* Except as provided in section 402(g) and paragraph (f) of this section, elective contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash or other taxable amounts would have been includible in the employee's gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan. See § 1.402(a)-1(d)(2)(i).

(iv) *Application of nondiscrimination requirements to plan that includes a qualified cash or deferred arrangement.* A plan that includes a qualified cash or deferred arrangement must satisfy the requirements of section 401(a)(4). Thus, for example, the plan must satisfy section 401(a)(4) with respect to the amount of contributions or benefits and the availability of benefits, rights and features under the plan. The right to make each level of elective contributions under a cash or deferred arrangement is a benefit, right or feature subject to this requirement, and each of these rights must therefore generally be available to a group of employees that satisfies section 410(b). Thus, for example, if all employees are eligible to make a stated level of elective contributions under a cash or deferred arrangement, but that level of contributions can only be made from compensation in excess of a stated amount, such as the Social Security taxable wage base, the arrangement will generally favor highly compensated employees with respect to the availability of elective contributions and thus will generally not satisfy the requirements of section 401(a)(4). For plan years beginning after December 31, 1984, the amount of elective contributions under a qualified cash or deferred arrangement satisfies the requirements of section 401(a)(4) only if the amount of elective contributions satisfies the special nondiscrimination test of section 401(k)(3) and paragraph (b)(2) of this section.

(5) *Rules applicable to nonqualified cash or deferred arrangements—(i) Definition of nonqualified cash or deferred arrangement.* A nonqualified cash or deferred arrangement is a cash or deferred arrangement that is not a qualified cash or deferred arrangement. Thus, if a cash or deferred arrangement fails to satisfy one or more of the

requirements in paragraph (b), (c), (d) or (e) of this section, the arrangement is a nonqualified cash or deferred arrangement.

(ii) *Treatment of elective contributions as employer contributions.* Except as specifically provided otherwise, elective contributions under a nonqualified cash or deferred arrangement are treated as nonelective employer contributions. Thus, for example, the elective contributions are treated as nonelective employer contributions for purposes of sections 401(a) (including section 401(a)(4)) and 401(k), 404, 409, 411, 412, 415, 416, and 417 and are not subject to the requirements of section 401(m).

(iii) *Tax treatment of employees.* Elective contributions under a nonqualified cash or deferred arrangement are includible in an employee's gross income at the time the cash or other taxable amount that the employee would have received (but for the cash or deferred election) would have been includible in the employee's gross income. See § 1.402(a)-1(d)(1).

(iv) *Qualification of plan that includes a nonqualified cash or deferred arrangement.* A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a nonqualified cash or deferred arrangement. In determining whether the plan satisfies the requirements of section 401(a)(4), the special nondiscrimination tests of sections 401(k)(3) and 401(m)(2) may not be used.

(6) *Rules applicable to partnership cash or deferred arrangements—(i) Application of general rules.* A partnership may maintain a cash or deferred arrangement, and individual partners may make cash or deferred elections with respect to compensation attributable to services rendered to the partnership. Generally, the same rules apply to partnership cash or deferred arrangements as apply to other cash or deferred arrangements. Thus, a partnership cash or deferred arrangement is not a qualified cash or deferred arrangement unless the requirements of section 401(k) and this section are satisfied. For example, any contributions made on behalf of an individual partner pursuant to a partnership cash or deferred arrangement are elective contributions unless they are designated or treated as after-tax employee contributions. Consistent with § 1.402(a)-1(d), the elective contributions are includible in income and are not deductible under section 404(a) unless the arrangement is

a qualified cash or deferred arrangement. Also, even if the arrangement is a qualified cash or deferred arrangement, the elective contributions are includible in gross income and are not deductible under section 404(a) to the extent they exceed the applicable limit under section 402(g). See also § 1.401(a)-30.

(ii) *Definition of partnership cash or deferred arrangement—(A) General rule.* Effective for contributions made for plan years beginning after December 31, 1988, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf.

(B) *Timing of partner's cash or deferred election.* For purposes of paragraph (a)(3)(ii) of this section, a partner's compensation is deemed currently available on the last day of the partnership taxable year. Accordingly, an individual partner may not make a cash or deferred election with respect to compensation for a partnership taxable year after the last day of that year. A partner's compensation for a partnership taxable year ending with or within a plan year beginning before October 15, 1991, is, however, deemed not to be currently available until the due date, including extensions, for filing the partnership's federal income tax return for its taxable year ending with or within the plan year. See § 1.401(k)-1(b)(4)(iii) for the rules regarding when contributions are treated as allocated.

(C) *Transition rule for partnership cash or deferred elections.* A one-time irrevocable election to participate or not to participate in a plan in which partners may participate is not a cash or deferred election if the election was made on or before the later of the first day of the first plan year beginning after December 31, 1988, or March 31, 1989. This election may be made after the commencement of employment or after the employee's first becoming eligible under any plan of the employer. The election may be made even if the one-time irrevocable election in § 1.401(k)-1(a)(3)(iv) was previously made.

(iii) *Treatment of certain matching contributions as elective contributions.* If a partnership makes matching contributions with respect to an individual partner's elective contributions or employee contributions, then the matching contributions are treated as elective contributions made on behalf of the partner. In the case of a plan that, on August 8, 1988, did not treat matching contributions as elective contributions, the preceding sentence applies only to plan years beginning

after August 8, 1988. See also §§ 1.401(m)-1(f)(12) and 1.404(e)-1A(f).

(7) *Rules applicable to collectively bargained plans*—(i) *In general.* The amount of employer contributions under a nonqualified cash or deferred arrangement is treated as satisfying section 401(a)(4) if the arrangement is part of a collectively bargained plan (including a plan adopted by a state or local government before May 6, 1986) that automatically satisfies the requirements of section 410(b). Except as specifically provided otherwise, elective contributions under the arrangement are treated as employer contributions. See § 1.401(k)-1(a)(5)(ii). However, elective contributions under the nonqualified cash or deferred arrangement are treated as employee contributions for purpose of section 402(a) for plan years beginning after December 31, 1992, and are therefore includible in gross income under section 402(a)(8). See § 1.402(a)-1(d)(3)(iv).

(ii) *Example.* The provisions of this paragraph (a)(7) are illustrated by the following example:

Example. For the 1994 plan year, Employer A maintains a collectively bargained plan that includes a cash or deferred arrangement. Employer contributions under the cash or deferred arrangement not satisfy the actual deferral percentage test of section 401(k)(3) and paragraph (b) of this section. Therefore, the arrangement is a nonqualified cash or deferred arrangement. The employer contributions under the cash or deferred arrangement are considered to be nondiscriminatory under section 401(a)(4), and the elective contributions are generally treated as employer contributions. Under § 1.402(a)-1(d)(1), however, elective contributions are includible in an employee's gross income.

(b) *Coverage and nondiscrimination requirements*—(1) *In general.* A cash or deferred arrangement satisfies this paragraph (b) for a plan year only if:

(i) The group of eligible employees under the cash or deferred arrangement satisfies the requirements of section 410(b) (including the average benefit percentage test, if applicable); and,

(ii) The cash or deferred arrangement satisfies the actual deferral percentage test described in paragraph (b)(2) of this section.

(2) *Actual deferral percentage test*—(i) *General rule.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (b) for a plan year only if:

(A) The actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage for the group of all

other eligible employees multiplied by 1.25; or

(B) The excess of the actual deferral percentage for the group of eligible highly compensated employees over the actual deferral percentage for the group of all other eligible employees is not more than two percentage points, and the actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage for the group of all other eligible employees multiplied by two.

An arrangement does not fail to satisfy the requirements of this paragraph (b)(2) merely because all of the eligible employees under an arrangement for a year are highly compensated employees.

(ii) *Rule for plan years beginning after 1979 and before 1987.* For plan years beginning after December 31, 1979, and before January 1, 1987, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (b) for a plan year only if:

(A) The actual deferral percentage for the group of eligible highly compensated employees (top one-third) is not more than the actual deferral percentage for the group of all other eligible employees (lower two-thirds) multiplied by 1.5; or

(B) The excess of the actual deferral percentage for the top one-third over the actual deferral percentage for the lower two-thirds is not more than three percentage points, and the actual deferral percentage for the top one-third is not more than the actual deferral percentage for the lower two-thirds multiplied by 2.5.

(iii) *Plan provision requirement.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, a plan that includes a cash or deferred arrangement does not satisfy the requirements of section 401(a) unless it provides that the actual deferral percentage test of section 401(k)(3) will be met. For purposes of this paragraph (b)(2)(iii), the plan may incorporate by reference the provisions of section 401(k)(3), this paragraph (b), and if applicable, section 401(m)(9) and § 1.401(m)-2.

(3) *Aggregation of arrangements and plans*—(i) *Aggregation of arrangements under plan.* Except as otherwise specifically provided in this paragraph (b)(3), all cash or deferred arrangements included in a plan are treated as a single cash or deferred arrangement. Thus, for example, if two groups of employees are eligible for separate cash or deferred arrangements under the same plan, the two cash or deferred arrangements are treated as a single cash or deferred arrangement, even if they have

significantly different features, such as significantly different limits on elective contributions. See § 1.401(k)-1(g)(11) for the definition of plan used for purposes of this section.

(ii) *Aggregation of plans*—(A) *General rule.* Plans that are aggregated for purposes of section 410(b) (other than for purposes of the average benefit percentage test) are treated as a single plan for purposes of section 401(k) and this section. Thus, cash or deferred arrangements included in plans that are aggregated for purposes of section 410(b) (other than the average benefit percentage test) are treated as a single cash or deferred arrangement. For example, if an employer maintains cash or deferred arrangements under separate profit-sharing plans for its salaried and hourly employees, and treats the plans as a single plan for purposes of section 410(b), the cash or deferred arrangements included in the plans are treated as a single arrangement. See also paragraph (g)(1)(ii) of this section for rules requiring the aggregation of elective contributions under two or more plans in computing the actual deferral ratios of certain employees.

(B) *Prohibited aggregation.* Except as specifically provided in this paragraph (b) and § 1.401(k)-1(g)(11), section 410(b) provides the exclusive means for aggregating plans for purposes of this section. For example, allocations under a plan or portion of a plan described in section 4975(e) or 409 (an ESOP) may not be combined with contributions or allocations under any plan or portion of a plan not described in section 4975(e) or 409 (a non-ESOP) for purposes of determining whether either the ESOP or the non-ESOP satisfies the requirements of section 401(k). Similarly, in the case of a plan maintained by more than one employer to which section 413(c) applies, section 401(k) and this section must be applied as if each employer maintained a separate plan. Also, a cash or deferred arrangement covering both employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are not so covered must be treated as two separate arrangements (one for each group of eligible employees) for purposes of section 401(k). Further, plans may not be aggregated unless they have the same plan year. In addition, plans that could be aggregated under section 410(b) but that are not actually aggregated for a year for purposes of section 410(b) (other than the average benefit percentage test) may not be aggregated for purposes of this section.

(iii) *Restructuring.* Effective for plan years beginning after December 31, 1991, restructuring may not be used to demonstrate compliance with the requirements of section 401(k). For plan years beginning before January 1, 1992, see § 1.401(k)-1(h)(3)(iii).

(iv) *Collectively bargained plans.* Participants in a collectively bargained plan to which section 413(b) applies are treated as employed by a single employer for purposes of section 401(k)(3) and (9), and paragraphs (b), (g)(1), and (g)(2) of this section. This special rule applies only if the participants are members of the collective bargaining unit, are employed by employers that are parties to the collective bargaining agreement, and are subject to the same contribution formula.

(4) *Elective contributions taken into account under the actual deferral percentage test—(i) General rule.* An elective contribution is taken into account under paragraph (b)(2) of this section for a plan year only if each of the following requirements is satisfied:

(A) The elective contribution is allocated to the employee's account under the plan as of a date within that plan year. For purposes of this rule, an elective contribution is considered allocated as of a date within a plan year only if—

(1) The allocation is not contingent upon the employee's participation in the plan or performance of services on any date subsequent to that date, and

(2) The elective contribution is actually paid to the trust no later than the end of the 12-month period immediately following the plan year to which the contribution relates.

(B) The elective contribution relates to compensation that either—

(1) Would have been received by the employee in the plan year but for the employee's election to defer under the arrangement, or

(2) Is attributable to services performed by the employee in the plan year and, but for the employee's election to defer, would have been received by the employee within two and one-half months after the close of the plan year.

(ii) *Elective contributions used to satisfy actual contribution percentage test.* Except as provided in § 1.401(m)-1(b)(5)(iii), elective contributions treated as matching contributions must satisfy the actual contribution percentage test of section 401(m)(2) and are not taken into account under paragraph (b)(2) of this section.

(iii) *Elective contributions for partners.* For purposes of paragraph (b)(2) of this section, a partner's distributive share of partnership income is treated as received on the last day of

the partnership taxable year. Thus, an elective contribution made on behalf of a partner is treated as allocated to the partner's account for the plan year that includes the last day of the partnership taxable year, provided the requirements of paragraph (b)(4)(i)(A) of this section are met.

(iv) *Elective contributions not taken into account.* Elective contributions that do not satisfy the requirements of paragraph (b)(4)(i) of this section may not use the special nondiscrimination rule of section 401(k)(3) and paragraph (b)(2) of this section for the plan year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the elective contributions must satisfy the requirements of section 401(a)(4) (without regard to the special nondiscrimination test in section 401(k)(3) and paragraph (b)(2) of this section) for the plan year in which they are allocated under the plan as if they were nonelective employer contributions and were the only nonelective employer contributions for the year.

(5) *Qualified nonelective contributions and qualified matching contributions that may be taken into account under the actual deferral percentage test.* Except as specifically provided otherwise, for purposes of paragraph (b)(2) of this section, all or part of the qualified nonelective contributions and qualified matching contributions made with respect to any or all employees who are eligible employees under the cash or deferred arrangement being tested may be treated as elective contributions under the arrangement, provided that each of the following requirements (to the extent applicable) is satisfied:

(i) The amount of nonelective contributions, including those qualified nonelective contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfies the requirements of section 401(a)(4).

(ii) The amount of nonelective contributions, excluding those qualified nonelective contributions treated as elective contributions for purposes of the actual deferral percentage test and those qualified nonelective contributions treated as matching contributions under § 1.401(m)-1(b)(5) for purposes of the actual contribution percentage test, satisfies the requirements of section 401(a)(4).

(iii) For plan years beginning before January 1, 1987, or such later date provided in paragraph (h) of this section, the matching contributions, including those qualified matching contributions

treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(iv) For plan years beginning before January 1, 1987, or such later date provided in paragraph (h) of this section, the matching contributions, excluding those qualified matching contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(v) The qualified nonelective contributions and qualified matching contributions satisfy the requirements of paragraph (b)(4)(i) of this section for the plan year as if the contributions were elective contributions.

(vi) For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, the plan that includes the cash or deferred arrangement and the plan or plans to which the qualified nonelective contributions and qualified matching contributions are made, could be aggregated for purposes of section 410(b) (other than the average benefit percentage test). If the plan year of the plan that includes the cash or deferred arrangement is changed to satisfy the requirement under section 410(b) that aggregated plans have the same plan year, the qualified nonelective contributions and qualified matching contributions may be taken into account in the resulting short plan year only if the contributions satisfy the requirements of paragraph (b)(4)(i) of this section with respect to the short year as if the contributions were elective contributions and the aggregated plans could otherwise be aggregated for purposes of section 410(b).

(6) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples.

Example 1. (i) Employees A, B, and C are eligible employees who earn \$30,000, \$15,000, and \$10,000, respectively, in 1989. In addition, their employer, X, contributes a bonus of up to 10 percent of their regular compensation to a trust under a profit-sharing plan that includes a cash or deferred arrangement. Under the arrangement, each eligible employee may elect to receive none, all, or any part of the 10 percent in cash. The employer contributes the remainder to the trust. The cash portion of the bonus, if any, is paid after the end of the plan year. The 10 percent is therefore not included in compensation until the year paid. Employee A is highly compensated. For the 1989 plan year, A, B, and C make the following elections:

Employee	Compensation	Elective contribution
A.....	\$30,000	\$1,780
B.....	15,000	750
C.....	10,000	450

(ii) The ratios of employer contributions to the trust on behalf of each eligible employee to the employee's compensation for the plan year (calculated separately for each employee) are:

Employee	Ratio of elective contribution to compensation	Actual deferral ratio (percent)
A.....	\$1,780/30,000	5.93
B.....	750/15,000	5.00
C.....	450/10,000	4.50

(iii) The actual deferral percentage for the highly compensated group (Employee A) is 5.93 percent. The actual deferral percentage for the nonhighly compensated group is 4.75 percent $((5\% + 4.5\%)/2)$. Because 5.93 percent is less than 5.94 percent (4.75% multiplied by 1.25), the first percentage test is satisfied.

Example 2. (i) The facts are the same as in **Example 1**, except that elective contributions are made pursuant to a salary reduction agreement and no bonuses are paid. Compensation includes amounts that are contributed by salary reduction. In addition, A defers \$2,025. Thus, the compensation and elective contributions for A, B, and C are:

Employee	Compensation	Elective contribution	Actual deferral ratio (percent)
A.....	\$30,000	\$2,025	6.75
B.....	15,000	750	5.00
C.....	10,000	450	4.50

(ii) The actual deferral percentage for the highly compensated group (Employee A) is 6.75 percent. The actual deferral percentage for the nonhighly compensated group is 4.75 percent $((5.00\% + 4.50\%)/2)$. Because 6.75 percent exceeds 5.94 percent (4.75×1.25) , the first percentage test is not satisfied. However, since the actual deferral percentage equals the maximum percentage allowed under the second percentage test, $(4.75 + 2 = 6.75)$, the second percentage test is satisfied.

Example 3. (i) Employees D through K are eligible employees in Employer A's profit-sharing plan that contains a cash or deferred arrangement. Each eligible employee may elect to defer up to six percent of compensation under the cash or deferred arrangement. Employees D and E are highly compensated. The compensation, elective contributions, and actual deferral ratios of these employees for the 1989 plan year are shown below:

Employee	Compensation	Elective contributions	Actual deferral ratio (percent)
D.....	\$100,000	\$6,000	6
E.....	80,000	4,000	5
F.....	60,000	3,600	6
G.....	40,000	1,600	4
H.....	30,000	1,200	4
I.....	20,000	600	3
J.....	20,000	600	3
K.....	10,000	300	3
L.....	5,000	150	3

(ii) The actual deferral percentage for the highly compensated group is 5.5 percent. The actual deferral percentage for the nonhighly compensated group is 3.71 percent. Because 5.5 percent is greater than 4.64 percent $(3.71\% \times 1.25)$, the first percentage test is not satisfied. However, because 5.5 percent is less than 5.71 percent (the lesser of $3.71\% + 2$ or $3.71\% \times 2$), the second percentage test is satisfied.

Example 4. (i) Employer D maintains a profit-sharing plan that contains a cash or deferred arrangement. The following amounts are contributed under the plan:

(A) Six percent of each employee's compensation. These contributions are not qualified nonelective contributions (QNCs).

(B) Two percent of each employee's compensation. These contributions are QNCs.

(C) Three percent of each employee's compensation that the employee may elect to receive as cash or to defer under the plan.

(ii) For the 1990 plan year, the compensation, elective contributions, and actual deferral ratios of employees M through S were:

Employee	Compensation	Elective contributions	Actual deferral ratio (percent)
M.....	\$100,000	\$3,000	3
N.....	80,000	1,600	2
O.....	60,000	1,800	3
P.....	40,000	0	0
Q.....	30,000	0	0
R.....	20,000	0	0
S.....	20,000	0	0

(iii) Both types of nonelective contributions are made for all employees. Thus, both the six percent and the two percent employer contributions satisfy the requirements of section 401(a)(4) and paragraph (b)(5)(i) of this section.

(iv) The elective contributions alone do not satisfy the special rules in paragraph (b)(4) of this section because the actual deferral percentage for the highly compensated group, consisting of employees M and N, is 2.5 percent and the actual deferral percentage for the nonhighly compensated group is 0.6 percent. However, the two percent QNCs may be taken into account in applying the special rules. The six percent nonelective contributions may not be taken into account because they are not QNCs.

(v) If the two percent QNCs are taken into account, the actual deferral percentage for the highly compensated group is 4.5 percent,

and the actual deferral percentage for the nonhighly compensated group is 2.6 percent. Because 4.5 percent is not more than two percentage points greater than 2.6 percent, and not more than two times 2.6, the actual deferral percentage test of section 401(k)(3) and paragraph (b)(2) of this section is satisfied. Thus, the plan satisfies this paragraph (b).

Example 5. (i) Employer N maintains a plan that contains a cash or deferred arrangement. The plan year and the employer's taxable year are the calendar year. The plan provides for employee contributions, elective contributions, matching contributions, and qualified nonelective contributions (QNCs), all of which meet the applicable requirements of section 401(a)(4). Matching contributions on behalf of nonhighly compensated employees are qualified matching contributions (QMACs). Matching contributions on behalf of highly compensated employees are not QMACs. For the 1988 plan year, elective contributions and matching contributions with respect to highly compensated and nonhighly compensated employees are shown in the following chart.

	Elective contributions (including QNCs) (percent)	Total matching contributions (percent)	QMACs (percent)
Highly compensated.....	15	5	0
Nonhighly compensated.....	11	5	5

(ii) The plan fails to meet the requirements of section 401(k)(3)(A) because 15 percent is more than 125 percent of, and more than two percentage points greater than, 11 percent. However, the plan provides that QMACs may be used to meet the requirements of section 401(k)(3)(A)(ii) to the extent needed under that section. Under this provision, the plan takes QMACs of one percent of compensation into account for each nonhighly compensated employee in applying the actual deferral percentage test. After this adjustment, the actual deferral and actual contribution percentages are as follows:

	Actual deferral percentage	Actual contribution percentage
Highly compensated.....	15	5
Nonhighly compensated.....	12	4

(iii) The elective contributions and QMACs taken into account under section 401(k) meet the requirements of section 401(k)(3)(A)(ii) because 15 percent is 125 percent of 12 percent. The remaining matching contributions meet the requirements of section 401(m) because five percent is 125 percent of four percent.

(c) **Nonforfeiture requirement—(1) General rule.** A cash or deferred arrangement satisfies this paragraph (c)

only if the elective contributions meet each of the following requirements:

(i) Each employee's right to the amount attributable to elective contributions is immediately nonforfeitable within the meaning of section 411, and would be nonforfeitable under the plan regardless of the age and service of the employee or whether the employee is employed on a specific date. A contribution that is subject to forfeitures or suspensions permitted by section 411(a)(3) does not satisfy the requirements of this paragraph (c).

(ii) The contributions are disregarded for purposes of applying section 411(a) to other contributions or benefits.

(iii) The contributions remain nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.

(2) *Example.* The provisions of this paragraph (c) are illustrated by the following example:

Example. (i) Employees B and C are covered by Employer Y's stock bonus plan, which includes a cash or deferred arrangement. Under the plan, Employer Y makes a nonelective contribution on behalf of each employee equal to four percent of compensation. All employees participating in the plan have a nonforfeitable right to a percentage of their accrued benefit derived from this contribution as shown in the following table:

Years of service	Nonforfeitable percentage
Less than 1.....	0
1.....	20
2.....	40
3.....	60
4.....	80
5 or more.....	100

(ii) B and C have three and six years of service, respectively. Employer Y also permits employees to elect to defer up to 6 percent of compensation through salary reduction agreements. Amounts deferred under these agreements are nonforfeitable at all times. In accordance with paragraph (c)(1)(i) of this section, the nonforfeitable percentage of Employer Y's nonelective contribution on behalf of B and C may not be treated as a qualified nonelective contribution under paragraph (b)(3) of this section, because these amounts are nonforfeitable by reason of the completion by B and C of a stated number of years of service, and not regardless of the age and service of B and C.

(d) *Distribution limitation*—(1) *General rule.* A cash or deferred arrangement satisfies this paragraph (d) only if amounts attributable to elective contributions may not be distributed before one of the following events, and any distributions so permitted also

satisfy the requirements of paragraphs (d) (2) through (6) of this section (to the extent applicable):

(i) The employee's retirement, death, disability, or separation from service.

(ii) In the case of a profit-sharing or stock bonus plan, the employee's attainment of age 59½, or the employee's hardship.

(iii) For plan years beginning after December 31, 1984, the termination of the plan.

(iv) For plan years beginning after December 31, 1984, the date of the sale or other disposition by a corporation of substantially all the assets (within the meaning of section 409(d)(2)) used by the corporation in a trade or business of the corporation to an unrelated corporation.

(v) For plan years beginning after December 31, 1984, the date of the sale or other disposition by a corporation of its interest in a subsidiary (within the meaning of section 409(d)(3)) to an unrelated entity or individual.

(2) *Rules applicable to hardship distributions*—(i) *Distribution must be on account of hardship.* A distribution is treated as made after an employee's hardship for purposes of paragraph (d)(1)(ii) of this section only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan. See section 411(d)(6) and the regulations thereunder.

(ii) *Limit on distributable amount.* For plan years beginning after December 31, 1984, a distribution on account of hardship must be limited to the distributable amount. The distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions on account of hardship. If the plan so provides, the employee's total elective contributions used in determining the distributable amount may be increased by income allocable to elective contributions, by amounts treated as elective contributions under paragraph (b)(5) of this section, and by income allocable to amounts treated as elective contributions. In each case, the distributable amount may only include amounts that were credited to the employee's account as of a date

specified in the plan that is no later than the end of the last plan year ending before July 1, 1989 (or such later date provided in paragraph (h) of this section). g

(iii) *General hardship distribution standards*—(A) *Immediate and heavy financial need.* Whether an employee has an immediate and heavy financial need is to be determined based on all relevant facts and circumstances. Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

(B) *Distribution necessary to satisfy financial need.* A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the amount of the distribution is in excess of the amount required to relieve the financial need or to the extent the need may be satisfied from other resources that are reasonably available to the employee. This determination generally is to be made on the basis of all relevant facts and circumstances. For purposes of this paragraph, the employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act is not treated as a resource of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution. A distribution generally may be treated as necessary to satisfy a financial need if the employer relies upon the employee's written representation, unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved:

(1) Through reimbursement or compensation by insurance or otherwise;

(2) By liquidation of the employee's assets;

(3) By cessation of elective contributions or employee contributions under the plan; or

(4) By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

For purposes of this paragraph (d)(2)(iii)(B), a need cannot reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

(iv) *Deemed hardship distribution standards*—(A) *Deemed immediate and heavy financial need.* A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

(1) Expenses for medical care described in section 213(d) previously incurred by the employee, the employee's spouse, or any dependents of the employee (as defined in section 152) or necessary for these persons to obtain medical care described in section 213(d);

(2) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(3) Payment of tuition and related educational fees for the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents (as defined in section 152); or

(4) Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence.

(B) *Distribution deemed necessary to satisfy financial need.* A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if all of the following requirements are satisfied:

(1) The distribution is not in excess of the amount of the immediate and heavy financial need of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

(2) The employee has obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently

available under all plans maintained by the employer.

(3) The plan and all other plans maintained by the employer limit the employee's elective contributions for the next taxable year to the applicable limit under section 402(g) for that year minus the employee's elective contributions for the year of the hardship distribution.

(4) The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution. For this purpose the phrase "all other plans maintained by the employer" means all qualified and nonqualified plans of deferred compensation maintained by the employer. The phrase includes a stock option, stock purchase, or similar plan, or a cash or deferred arrangement that is part of a cafeteria plan within the meaning of section 125. However, it does not include the mandatory employee contribution portion of a defined benefit plan. It also does not include a health or welfare benefit plan, including one that is part of a cafeteria plan within the meaning of section 125. See § 1.401(k)-1(g)(4)(i) for the continued treatment of suspended employees as eligible employees.

(C) *Commissioner may expand standards.* The Commissioner may expand the list of deemed immediate and heavy financial needs and may prescribe additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need only in revenue rulings, notices, and other documents of general applicability, and not on an individual basis.

(3) *Rules applicable to distributions upon plan termination.* A distribution may not be made under paragraph (d)(1)(iii) of this section if the employer establishes or maintains a successor plan. For purposes of this rule, a successor plan is any other defined contribution plan maintained by the same employer. However, if fewer than two percent of the employees who are eligible under the plan that includes the cash or deferred arrangement at the time of its termination are or were eligible under another defined contribution plan at any time during the 24 month period beginning 12 months before the time of the termination, the other plan is not a successor plan. The term "defined contribution plan" means a plan that is a defined contribution plan as defined in section 414(i), but does not include an employee stock ownership plan as defined in section 4975(e) or 409 or a

simplified employee pension as defined in section 408(k). A plan is a successor plan only if it exists at the time the plan including the cash or deferred arrangement is terminated or within the period ending 12 months after distribution of all assets from the plan.

(4) *Rules applicable to distributions upon sale of assets or subsidiary*—(i) *Seller must maintain the plan.* A distribution may be made under section 401(k)(10) and paragraph (d)(1) (iv) or (v) of this section only from a plan that the seller continues to maintain after the disposition. This requirement is satisfied only if the purchaser does not maintain the plan after the disposition. A purchaser maintains the plan of the seller if it adopts the plan or otherwise becomes an employer whose employees accrue benefits under the plan. A purchaser also maintains the plan if the plan is merged or consolidated with, or any assets or liabilities are transferred from the plan to, a plan maintained by the purchaser in a transaction subject to section 414(l)(1). A purchaser is not treated as maintaining the plan merely because a plan that it maintains accepts rollover contributions of amounts distributed by the plan.

(ii) *Employee must continue employment.* A distribution may be made under paragraph (d)(1) (iv) or (v) of this section only to an employee who continues employment with the purchaser of assets or with the subsidiary, whichever is applicable.

(iii) *Distribution must be in connection with disposition of assets or subsidiary.* Elective contributions may not be distributed under paragraph (d)(1) (iv) or (v) of this section except in connection with the disposition that results in the employee's transfer to the purchaser. Whether a distribution is made in connection with the disposition of assets or a subsidiary depends on all of the facts and circumstances. Except in unusual circumstances, however, a distribution will not be treated as having been made in connection with a disposition unless it was made by the end of the second calendar year after the calendar year in which the disposition occurred.

(iv) *Definitions*—(A) *Substantially all.* For purposes of paragraph (d)(1)(iv) of this section, the sale of "substantially all" the assets used in a trade or business means the sale of at least 85 percent of the assets.

(B) *Unrelated employer.* For purposes of paragraph (d)(1) (iv) and (v) of this section, an "unrelated" entity or individual is one that is not required to be aggregated with the seller under

section 414 (b), (c), (m), or (o) after the sale or other disposition.

(5) *Lump sum requirement for certain distributions.* After March 31, 1988, a distribution may be made under paragraph (d)(1) (iii), (iv), or (v) of this section only if it is a lump sum distribution. The term "lump sum distribution" has the meaning provided in section 402(e)(4), without regard to subparagraphs (A) (i) through (iv), (B), and (H) of that section.

(6) *Rules applicable to all distributions—(i) Impermissible distributions.* Amounts attributable to elective contributions may not be distributed on account of any event not described in this paragraph (d), such as completion of a stated period of plan participation or the lapse of a fixed number of years. For example, if excess deferrals (and income) for an employee's taxable year are not distributed within the time prescribed in § 1.402(g)-1(e) (2) or (3), the amounts may be distributed only on account of an event described in this paragraph (d).

(ii) *Deemed distributions.* The cost of life insurance (P.S. 58 costs) is not treated as a distribution for purposes of section 401(k)(2) and this paragraph. The making of a loan is not treated as a distribution, even if the loan is secured by the employee's accrued benefit attributable to elective contributions or is includible in the employee's income under section 72(p). However, the reduction, by reason of default on a loan, of an employee's accrued benefit derived from elective contributions is treated as a distribution.

(iii) *ESOP dividend distributions.* A plan does not fail to satisfy the requirements of this paragraph (d) merely by reason of a dividend distribution described in section 404(k)(2).

(iv) *Limitations apply after transfer.* The limitations of this paragraph (d) generally continue to apply to amounts attributable to elective contributions (including amounts treated as elective contributions) that are transferred to another qualified plan of the same or another employer. Thus, the transferee plan will generally fail to satisfy the requirements of section 401(a) and this section if transferred amounts may be distributed before the times specified in this paragraph (d). The limitations of paragraph (d) of this section cease to apply after the transfer, however, if the amounts could have been distributed at the time of the transfer (other than on account of hardship), and the transfer is an elective transfer described in § 1.411(d)-4, Q&A-3(b)(1).

(v) *Required consent.* A distribution may be made under this paragraph (d)

only if any consent or election required under section 411(a)(11) or 417 is obtained.

(7) *Examples.* The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. Employer C maintains a profit-sharing plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be withdrawn for any reason after two years following the end of the plan year in which the contributions were made. Because the plan permits distributions of elective contributions before the occurrence of one of the events specified in section 401(k)(2)(B) and this paragraph (d), the plan includes a nonqualified cash or deferred arrangement and the elective contributions are currently includible in income under section 402.

Example 2. Employer D maintains a pre-ERISA money purchase plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be distributed to an employee on account of hardship. Under paragraph (d)(1) of this section, hardship is a distribution event only in a profit-sharing or stock bonus plan. Since elective contributions under the arrangement may be distributed before a distribution event occurs, the cash or deferred arrangement does not satisfy this paragraph (d), and is not a qualified cash or deferred arrangement. Moreover, the plan is not a qualified plan because a pension plan may not provide for payment of benefits upon hardship. See § 1.401-1(b)(1)(i).

(e) *Additional requirements for qualified cash or deferred arrangements—(1) Qualified profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan requirement.* A cash or deferred arrangement satisfies this paragraph (e) only if the plan of which it is a part is a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan that otherwise satisfies the requirements of section 401(a) (taking into account the cash or deferred arrangement). A plan that includes a cash or deferred arrangement may provide for other contributions, including employer contributions (other than elective contributions), employee contributions, or both. See paragraph (e) of this section, however, for limitations on the extent to which elective contributions under a cash or deferred arrangement may be taken into account in determining whether the other contributions satisfy the requirements of section 401(a).

(2) *Cash availability requirement.* A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides that the amount that each eligible employee may defer as an elective contribution is available to the employee in cash. Thus, for example, if an eligible employee is

provided the option to receive a taxable benefit (other than cash) or to have the employer contribute on the employee's behalf to a profit-sharing plan an amount equal to the value of the taxable benefit, the arrangement is not a qualified cash or deferred arrangement. Similarly, if an employee has the option to receive a specified amount in cash or to have the employer contribute an amount in excess of the specified cash amount to a profit-sharing plan on the employee's behalf, any contribution made by the employer on the employee's behalf in excess of the specified cash amount is not treated as made pursuant to a qualified cash or deferred arrangement. This cash availability requirement applies even if the cash or deferred arrangement is part of a cafeteria plan within the meaning of section 125.

(3) *Separate accounting requirement—(i) General rule.* A cash or deferred arrangement satisfies this paragraph (e) only if the portion of an employee's benefit subject to the requirements of paragraphs (c) and (d) of this section is determined by an acceptable separate accounting between that portion and any other benefits. Separate accounting is not acceptable unless gains, losses, withdrawals, and other credits or charges are separately allocated on a reasonable and consistent basis to the accounts subject to the requirements of paragraphs (c) and (d) of this section and to other accounts. Subject to section 401(a)(4), forfeitures are not required to be allocated to the accounts in which benefits are subject to paragraphs (c) and (d) of this section.

(ii) *Failure to satisfy separate accounting requirement.* The requirements of paragraph (e)(3)(i) of this section are treated as satisfied if all amounts held under a plan that includes a cash or deferred arrangement or under another plan, contributions under which are taken into account under the arrangement for purposes of paragraph (b) of this section are treated as attributable to elective contributions subject to the requirements of paragraphs (c) and (d) of this section.

(4) *Limitations on cash or deferred arrangements of state and local governments and tax-exempt organizations—(i)* A cash or deferred arrangement does not satisfy the requirements of this paragraph (e) if the arrangement is adopted:

(A) After May 6, 1986, by a state or local government or political subdivision thereof, or any agency or instrumentality thereof ("a governmental unit"), or

(B) After July 1, 1986, by any organization exempt from tax under subtitle A of the Internal Revenue Code. For purposes of paragraph (e)(4) of this section, whether an organization is exempt from tax under subtitle A of the Internal Revenue Code is determined without regard to section 414 (b), (c), (m) or (o).

(ii) A cash or deferred arrangement is treated as adopted after the dates described in paragraph (e)(4)(i) of this section with respect to all employees of any employer that adopts the arrangement after such dates. If an employer adopted an arrangement prior to such dates, all employees of the employer may participate in the arrangement.

(iii) For purposes of this paragraph (e)(4), an employer that has made a legally binding commitment to adopt a cash or deferred arrangement is treated as having adopted the arrangement on that date.

(iv) If a governmental unit adopted a cash or deferred arrangement before May 7, 1986, then any cash or deferred arrangement adopted by the unit at any time is treated as adopted before that date.

(v) This paragraph (e)(4) does not apply to a rural cooperative plan.

(vi) For purposes of this paragraph (e)(4), an employee representative is treated as an employee of a tax exempt employer even if the employee could be treated as an employee by another employer under § 1.413-1(i)(1).

(5) *One-year eligibility requirement.* For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if no employee is required to complete a period of service greater than one year (determined without regard to section 410(a)(1)(B)(i)) with the employer maintaining the plan to be eligible to make an election under the arrangement.

(6) *Other benefits not contingent upon elective contributions—(i) General rule.* For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if no other benefit is conditioned (directly or indirectly) upon the employee's electing to make or not to make elective contributions under the arrangement. The preceding sentence does not apply to any matching contribution (as defined in section 401(m)) made by reason of such an election or to any benefit that is provided at the employee's election under a plan described in section 125(d)

in lieu of an elective contribution under a qualified cash or deferred arrangement.

(ii) *Definition of other benefits.* Other benefits include, but are not limited to, benefits under a defined benefit plan; nonelective employer contributions under a defined contribution plan; the availability, cost, or amount of health benefits; vacations or vacation pay; life insurance; dental plans; legal services plans; loans (including plan loans); financial planning services; subsidized retirement benefits; stock options; property subject to section 83; and dependent care assistance. Also, increases in salary and bonuses (other than those actually subject to the cash or deferred election) are benefits for purposes of this paragraph (e)(6). The ability to make after-tax employee contributions is a benefit, but that benefit is not contingent upon an employee's electing to make or not make elective contributions under the arrangement merely because the amount of elective contributions reduces dollar-for-dollar the amount of after-tax employee contributions that may be made.

(iii) *Effect of certain statutory limits.* A benefit under a defined benefit plan that is contingent upon elective contributions solely by reason of the combined plan fraction of section 415(e) is not treated as contingent for purposes of this paragraph (e)(6). Similarly, any benefit under an excess benefit plan described in section 3(36) of the Employee Retirement Income Security Act of 1974 that is dependent on the employee's electing to make or not to make elective contributions is not treated as contingent.

(iv) *Nonqualified deferred compensation.* Participation in a nonqualified deferred compensation plan is treated as contingent for purposes of this paragraph (e)(6) only to the extent that an employee may receive additional deferred compensation under the nonqualified plan to the extent the employee makes or does not make elective contributions. Deferred compensation under a nonqualified plan of deferred compensation that is dependent on an employee's having made the maximum elective deferrals under section 402(g) or the maximum elective contributions permitted under the terms of the plan also is not treated as contingent.

(v) *Plan loans and distributions.* A loan or distribution of elective contributions is not a benefit conditioned on an employee's electing to make or not make elective contributions under the arrangement merely because the amount of the loan or distribution is

based on the amount of the employee's account balance.

(7) *Coordination with other plans.* For plan years beginning after December 31, 1988, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if no elective contributions (or qualified nonelective or qualified matching contributions treated as elective contributions under paragraph (b)(5) of this section) under the arrangement are taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the elective contributions are made) satisfy the requirements of section 401(a). For example, elective contributions under a cash or deferred arrangement generally may not be taken into account in determining whether a plan satisfies the minimum contribution or benefit requirements of section 416. See § 1.416-1, M-20. However, qualified nonelective contributions that are treated as elective contributions for purposes of section 401(k)(3) under paragraph (b)(5) of this section may be used to enable a plan to satisfy the minimum contribution or benefit requirements under section 416. See § 1.416-1, M-18. This paragraph (e) does not apply for purposes of determining whether a plan satisfies the average benefit percentage requirement of section 410(b)(2)(A)(ii). See also § 1.401(m)-1(b)(5) for circumstances under which elective contributions may be used to determine whether a plan satisfies the requirements of section 401(m).

(8) *Recordkeeping requirements.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (e) only if the employer maintains the records necessary to demonstrate compliance with the applicable nondiscrimination requirements of paragraph (b) of this section, including the extent to which qualified nonelective contributions and qualified matching contributions are taken into account.

(f) *Correction of excess contributions—(1) General rule—(i) Permissible correction methods.* A cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) or paragraph (b)(2) of this section with respect to the amount of elective contributions under the arrangement if the employer, in accordance with the terms of the plan that includes the cash or deferred arrangement and paragraph (b)(5) of this section, makes qualified nonelective

contributions or qualified matching contributions that are treated as elective contributions under the arrangement and that, in combination with the elective contributions, satisfy the requirements of paragraph (b)(2) of this section. In addition, a cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) or paragraph (b)(2) of this section for a plan year with respect to the amount of the elective contributions under the arrangement if, in accordance with the terms of the plan that includes the cash or deferred arrangement, excess contributions are recharacterized in accordance with paragraph (f)(3) of this section, or excess contributions (and income allocable thereto) are distributed in accordance with paragraph (f)(4) of this section.

(ii) *Combination of correction methods.* A plan may use any of the correction methods described in paragraph (f)(1)(i) of this section, may limit elective contributions in a manner designed to prevent excess contributions from being made, or may use a combination of these methods, to avoid or correct excess contributions. Thus, for example, a portion of the excess contributions for a highly compensated employee may be recharacterized under paragraph (f)(3) of this section, and the remaining portion of the excess contributions may be distributed under paragraph (f)(4) of this section. A plan may require or permit a highly compensated employee to elect whether any excess contributions are to be recharacterized or distributed.

(iii) *Impermissible correction methods.* Excess contributions for a plan year may not remain unallocated, or be allocated to a suspense account for allocation to one or more employees in any future year. See paragraph (f)(6) of this section with respect to the effects of a failure to correct excess contributions.

(iv) *Partial distributions.* Any distribution of less than the entire amount of excess contributions with respect to any highly compensated employee is treated as a pro rata distribution of excess contributions and allocable income or loss.

(2) *Amount of excess contributions.* The amount of excess contributions for a highly compensated employee for a plan year is the amount (if any) by which the employee's elective contributions must be reduced for the employee's actual deferral ratio to equal the highest permitted actual deferral ratio under the plan. To calculate the highest permitted actual deferral ratio under a plan, the actual deferral ratio of the highly compensated employee with the highest actual deferral ratio is

reduced by the amount required to cause the employee's actual deferral ratio to equal the ratio of the highly compensated employee with the next highest actual deferral ratio. If a lesser reduction would enable the arrangement to satisfy the actual deferral percentage test, only this lesser reduction may be made. This process must be repeated until the cash or deferred arrangement satisfies the actual deferral percentage test. The highest actual deferral ratio remaining under the plan after leveling is the highest permitted actual deferral ratio. In no case may the amount of excess contributions to be recharacterized or distributed for a plan year with respect to any highly compensated employee exceed the amount of elective contributions made on behalf of the highly compensated employee for the plan year.

(3) *Recharacterization of excess contributions—(i) General rule.* Excess contributions are recharacterized in accordance with this paragraph (f)(3) only if the excess contributions are treated as described in paragraph (f)(3)(ii) of this section, and all of the conditions set forth in paragraph (f)(3)(iii) of this section are satisfied.

(ii) *Treatment of recharacterized excess contributions.* Excess contributions recharacterized under this paragraph (f)(3) are includible in the employee's gross income on the earliest dates any elective contribution made on behalf of the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash, or on such later date permitted in paragraph (f)(3)(iv) of this section. The recharacterized excess contributions must be treated as employee contributions for purposes of section 72, section 401(a)(4) and 401(m), and paragraphs (b) and (d) of this section. This requirement is not treated as satisfied unless:

(A) The payor or plan administrator reports the recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by—

(1) Timely providing such forms as the Commissioner may designate to the employer and to employees whose excess contributions are recharacterized under this paragraph (f)(3); and

(2) Timely taking such other action as the Commissioner may require; and

(B) The plan administrator accounts for the amounts as contributions by the employee for purposes of sections 72 and 6047.

Recharacterized excess contributions continue to be treated as employer

contributions that are elective contributions for all other purposes under the Code, including sections 401(a) (other than 401(a)(4) and 401(m)), 404, 409, 411, 412, 415, 416, and 417, and, with respect to recharacterized excess contributions for plan years beginning after December 31, 1988, section 401(k)(2). Thus, for example, recharacterized excess contributions remain subject to the requirements of paragraph (c) of this section; must be deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A) and § 1.415-6(b). In addition, these amounts are not treated as compensation for purposes of sections 404 and 415, and may be treated as compensation for purposes of sections 401(a)(4), 401(a)(5), 401(k), 401(l) and 414(s) only to the extent that elective contributions may be treated, and are treated under the plan, as compensation. Recharacterized excess contributions that relate to plan years ending on or before October 24, 1988, may be treated as either employer contributions or employee contributions for purposes of paragraph (d) of this section. The amount of excess contributions included in an employee's gross income is reduced as provided under paragraph (f)(5)(i)(B) of this section.

(iii) *Additional rules—(A) Time of recharacterization.* Excess contributions may not be recharacterized under this paragraph (f)(3) after the later of October 24, 1988, or 2½ months after the close of the plan year to which the recharacterization relates. Recharacterization is deemed to have occurred on the date on which the last of those highly compensated employees with excess contributions to be recharacterized is notified in accordance with paragraph (f)(3)(ii)(A) of this section. The Commissioner may designate the means by which this notification is to be provided.

(B) *Employee contributions must be permitted under plan.* The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the highly compensated employee, may not exceed the maximum amount of employee contributions (determined without regard to the actual contribution percentage test of section 401(m)(2)) that the highly compensated employee could have made under the provisions of the plan in effect on the first day of the plan year in the absence of recharacterization. See § 1.401(m)-1(a)(2) for requirements relating to the availability of employee contributions.

(C) *Plans under which excess contributions may be recharacterized.* For plan years beginning after December 31, 1991, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with which that plan could be aggregated for purposes of section 410(b) (other than the average benefit percentage test). For plan years beginning before that date and after December 31, 1988, or such later date provided under paragraph (h) of this section, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with the same plan year as that plan.

(iv) *Transition rules.* If amounts recharacterized for any plan year were not previously included in income, they must be treated as received by employees for income tax purposes on the first day of the first plan year ending after 1987. If notice of recharacterization was provided to the affected highly compensated employees by October 24, 1988, recharacterization is deemed to have occurred 2½ months after the close of the plan year and the penalty tax of section 4979 will not be imposed. The rules in this paragraph (f)(3)(iv) are effective only for plan years ending before August 9, 1988.

(v) *Example.* The provisions of this paragraph (f)(3) are illustrated by the following example:

Example. (i) Employer X maintains Plan Y, a calendar year profit-sharing plan that includes a qualified cash or deferred arrangement. Under Plan Y, each eligible employee may elect to defer up to 10 percent of compensation under a salary reduction agreement. An eligible employee may also make employee contributions of up to 10 percent of compensation. X pays the amounts deferred under the trust on the last day of each month. Salaries are paid on the same date.

(ii) (A) In January 1989, X determines that during 1988 the compensation and actual deferral ratios (ADRs) of X's six employees were as follows:

Employee	Compensation (A)	Elective contribution (B)	ADR (%) (B/A)
A.....	\$70,000	\$7,000	10.00
B.....	60,000	4,500	7.50
C.....	20,000	1,000	5.00
D.....	15,000	0	0
E.....	10,000	350	3.50
F.....	10,000	350	3.50

(B) The average deferral percentage (ADP) for X's highly compensated group, A and B, is 8.75 percent $((10.00\% + 7.50\%)/2)$. The ADP for X's other employees is 3 percent $((5.00\% + 0\% + 3.50\% + 3.50\%)/4)$. Because 8.75 percent is

more than 2 times 3 percent and more than 3 percent plus 2 percentage points, the plan fails to satisfy paragraph (b)(2) of this section. Neither A nor B made any employee contributions for the year.

(iii) Plan Y provides that each highly compensated participant will have excess contributions, as defined in paragraph (g)(7) of this section, recharacterized. The amount to be recharacterized will be determined according to the method described in paragraph (f)(2) of this section.

(iv) In order to satisfy paragraph (b)(2) of this section, Plan Y must reduce the ADP for X's highly compensated employees to not more than 5 percent. This will satisfy the test described in paragraph (b)(2) of this section, because 5 percent is not more than 2 times 3 percent and is not more than 2 percentage points greater than 3 percent. Plan Y first reduces A's ADR to 7.5 percent (the ADR of the highly compensated employee having the next highest ADR). Since this is not sufficient to satisfy the ADP test in paragraph (b)(2) of this section, the ADR of both A and B must be reduced to 5 percent.

(v) The maximum dollar amount that may be deferred by each employee is determined by using the formula $D = (ADR \times S)$ where D is the maximum allowable deferral, ADR is the reduced ADR, and S is the compensation. Thus, A's maximum allowable deferral is \$3,500 $(.05 \times \$70,000)$, and B's maximum allowable deferral is \$3,000 $(.05 \times \$60,000)$. The balance of the original deferrals by A and B (\$3,500 and \$1,500 respectively) must be included in their taxable wages for 1988, the year in which X would have paid cash to A and B.

(vi) A deferred \$583.33 per month, except for January, February, March, and April, when A deferred \$583.34. Pursuant to the first-in, first-out rule in paragraph (f)(3)(ii) of this section, the deferrals made in January, February, March, April, and May, as well as \$583.31 of the deferral made in June, are treated as employee contributions. A similar procedure is undertaken with respect to B. X and the plan administrator provide A and B with the forms and notices that the Commissioner requires. If A and B had already filed income tax returns for 1988, they must file amended returns. If Plan Y had a plan year ending November 30, 1987, and A and B had made elective deferrals in December 1987, they would also have to file amended returns for 1987. In addition, the plan administrator must satisfy paragraph (f)(3)(ii)(B) of this section. Of course, the actual contribution percentage test of section 401(m)(2) must be satisfied for 1988, taking the recharacterized amounts into account.

(4) *Corrective distribution of excess contributions (and income)*—(i) *General rule.* Excess contributions (and income allocable thereto) are distributed in accordance with this paragraph (f)(4) only if the excess contributions and allocable income are designated by the employer as a distribution of excess contributions (and income), and are distributed to the appropriate highly compensated employees after the close of the plan year in which the excess

contributions arose and within 12 months after the close of that plan year. In the event of a complete termination of the plan during the plan year in which an excess contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of a highly compensated employee is distributed during the plan year in which an excess contribution arose, the distribution is deemed to have been a corrective distribution of excess contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(ii) *Income allocable to excess contributions*—(A) *General rule.* The income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year and, if the plan so provides, the allocable gain or loss for the period between the end of the plan year and the date of distribution (the "gap period").

(B) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts.

(C) *Alternative method of allocating income.* A plan may allocate income to excess contributions by multiplying the income for the plan year (and the gap period, if the plan so provides) allocable to elective contributions and amounts treated as elective contributions by a fraction. The numerator of the fraction is the excess contributions for the employee for the plan year. The denominator of the fraction is equal to the sum of:

(1) The total account balance of the employee attributable to elective contributions and amounts treated as elective contributions as of the beginning of the plan year; plus

(2) The employee's elective contributions and amounts treated as elective contributions for the plan year and for the gap period if gap period income is allocated.

(D) *Safe harbor method of allocating gap period income.* Under the safe harbor method, income on excess contributions for the gap period is equal to 10 percent of the income allocable to excess contributions for the plan year (calculated under the method described

in paragraph (f)(4)(ii)(C)) of this section, multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(iii) *No employee or spousal consent required.* A corrective distribution of excess contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(iv) *Treatment of corrective distributions as employer contributions.* Excess contributions are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan.

(v) *Tax treatment of corrective distributions—(A) General rule.* Except as provided in paragraph (f)(4)(v) (B) or (C) of this section, a corrective distribution of excess contributions (and income) that is made within 2½ months after the end of the plan year for which the excess contributions were made is includible in the employee's gross income on the earliest dates any elective contributions by the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash. A corrective distribution of excess contributions (and income) that is made more than 2½ months after the end of the plan year for which the contributions were made is includible in the employee's gross income in the employee's taxable year in which distributed. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A. See paragraph (f)(5)(i)(B) of this section for rules relating to the taxation of excess contributions that reduce excess deferrals. See paragraph (f)(6)(i) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year.

(B) *Rule for de minimis distributions.* If the total amount of excess contributions and excess aggregate contributions distributed to a recipient under a plan for any plan year is less than \$100 (excluding income), a corrective distribution of excess contributions (and income) is includible

in the gross income of the recipient in the taxable year of the recipient in which the corrective distribution is made.

(C) *Rule for certain 1987 and 1988 excess contributions.* Distributions for plan years beginning in 1987 and 1988 to which the de minimis rule of this section would otherwise apply may be reported by the recipient, at the recipient's option, either in the year described in paragraph (f)(4)(v)(A) of this section, or in the year described in paragraph (f)(4)(v)(B) of this section. This special rule may be used only for distributions made within 2½ months after the close of the plan year, but in no event later than April 17, 1989.

(vi) *No reduction of required minimum distribution.* A distribution of excess contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9).

(5) *Rules applicable to all corrections—(i) Coordination with distribution of excess deferrals—(A) In general.* The amount of excess contributions to be recharacterized under paragraph (f)(3) of this section or distributed under paragraph (f)(4) of this section with respect to an employee for a plan year, is reduced by any excess deferrals previously distributed to the employee for the employee's taxable year ending with or within the plan year in accordance with section 402(g)(2).

(B) *Treatment of excess contributions that reduce excess deferrals.* Under § 1.402(g)-1(d), the amount of excess deferrals that may be distributed with respect to an employee for a taxable year is reduced by any excess contributions previously distributed or recharacterized with respect to the employee for the plan year beginning with or within the taxable year. The amount of excess contributions includible in the gross income of the employee, and the amount of excess contributions reported by the payor or plan administrator as includible in the gross income of the employee, does not include the amount of any reduction under § 1.402(g)-1(e)(6).

(ii) *Correction of family members.* The determination and correction of excess contributions of a highly compensated employee whose actual deferral ratio is determined under the family aggregation rules of paragraph (g)(1)(ii)(C) of this section is accomplished by reducing the actual deferral ratio as required under paragraph (f)(2) of this section and allocating the excess contributions for the family group among the family members in proportion to the elective contribution of each family member that

is combined to determine the actual deferral ratio.

(iii) *Matching contributions forfeited because of excess deferral or contribution.* For purposes of section 401(k)(2)(C) and paragraph (c)(1) of this section, a qualified matching contribution is not treated as forfeitable merely because under the plan it is forfeited if the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution.

(6) *Failure to correct—(i) Failure to correct within 2½ months after end of plan year.* If a plan does not correct excess contributions within 2½ months after the close of the plan year for which the excess contributions are made, the employer will be liable for a 10-percent excise tax on the amount of the excess contributions. See section 4979 and § 54.4979-1. Qualified nonelective contributions and qualified matching contributions properly taken into account under paragraph (b)(5) of this section for a plan year may enable a plan to avoid having excess contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year.* If excess contributions are not corrected within 12 months after close of the plan year for which they were made, the cash or deferred arrangement will fail to satisfy the requirements of section 401(k)(3) for the plan year for which the excess contributions are made and all subsequent plan years during which the excess contributions remain in the trust.

(7) *Examples.* The provisions of this paragraph (f) are illustrated by the following examples:

Example 1. (i) The Y corporation maintains a cash or deferred arrangement. The plan year is the calendar year. For plan year 1989, all 10 of Y's employees are eligible to participate in the cash or deferred arrangement. The employees' compensation, elective deferrals, and actual deferral ratios are as shown in the following table:

Employee	Compensation	Elective deferral	Actual deferral ratio (%) (ADR)
A.....	160,000	6,400	4.0
B.....	140,000	7,000	5.0
C.....	70,000	7,000	10.0
D.....	65,000	6,500	10.0
E.....	42,000	2,100	5.0
F.....	35,000	3,500	10.0
G.....	28,000	2,800	10.0
H.....	21,000	700	3.33
I.....	21,000	0	0
J.....	21,000	0	0

(ii) Employees A, B, C, and D are highly compensated employees. Employees E, F, G, H, I, and J are nonhighly compensated employees. The actual deferral percentage (ADP) for the highly compensated group is 7.25 percent. The ADP for the nonhighly compensated group is 4.72 percent. These percentages do not meet the requirements of section 401(k)(3)(A)(ii).

(iii) Employees A and C have each received a distribution of excess deferrals of \$1,000. However, the ADR for employee A remains 4.0 percent and the actual deferral ratio for Employee C remains 10.0 percent. The ADP for the group of highly compensated group remains 7.25 percent.

(iv) The ADP for the highly compensated group must be reduced to 6.72 percent. This is done by reducing the ADR of the highly compensated employees with the highest ADR (Employees C and D) to 8.94 percent. This makes Employee C's maximum elective contribution \$9,258. This requires a distribution or recharacterization of \$742. But since \$1,000 has already been distributed as an excess deferral, no additional distribution or recharacterization is required or permitted. Employee D's elective contribution must be reduced by \$889 (\$8,500—\$8,094 (\$85,000)) to \$5,811 through distribution or recharacterization.

Example 2. A, B, and C are highly compensated employees of Employer R. Employer R maintains a cash or deferred arrangement. For the plan year 1990, A, B, and C each earn \$100,000 and contribute \$7,000 to the plan during the period January through June. B retires in November of 1990 and makes a withdrawal of B's entire account balance of \$200,000. In January of 1991, R computes the ADP test for its employees and learns that the highly compensated employees should have contributed only five percent of compensation. Since B made a contribution of \$7,000 for 1990, B's contribution and compensation are used in determining the ADP despite the subsequent \$200,000 withdrawal. A, B, and C must each receive a corrective distribution of \$2,000 in order to meet the ADP test. Since B has already withdrawn B's total account balance under the plan, only A and C must receive a distribution of \$2,000 each in order for the plan to meet the ADP test of section 401(k)(3)(A)(ii). Pursuant to the 1990 Form 1099-R Instructions, the plan must issue two Forms 1099-R to B, one reporting the portion of the distribution that was necessary to correct the excess contribution (including income), and one reporting the balance of the distribution. If B had withdrawn less than the total account balance, B would have to withdraw the lesser of \$2,000 or the remaining account balance.

Example 3. Individual A has a child, B. Both participate in a cash or deferred arrangement maintained by Employer X. A is one of the 10 most highly compensated employees and B is a nonhighly compensated employee. A has compensation of \$100,000 and defers \$7,000 under the cash or deferred arrangement; B has compensation of \$40,000 and defers \$4,000 under the arrangement. The actual deferral ratio of the family unit is 7.86 percent, calculated by aggregating the contributions and compensation of A and B

(\$7,000+\$4,000)/(\$100,000+\$40,000). For the plan, it is determined that under § 1.401(k)-1(f)(2), the actual deferral ratio of the aggregate family unit must be reduced to 7.20 percent. This reduction is applied in proportion to A's and B's contributions. The excess contributions are \$920 (\$11,000 total contributions minus \$10,080 (7.20%×\$140,000)). A's share of the excess contributions is \$585.45 (\$7,000/\$11,000×\$920); B's share is \$334.55 (\$4,000/\$11,000×\$920).

Example 4. (i) Employer T maintains a profit-sharing plan containing a cash or deferred arrangement for all employees. Six employees are covered by a collective bargaining agreement, the other seven employees are not. The employee data for 1994 is shown in the following table:

Employee	Collective bargaining unit status	Actual deferral ratio (ADR), (percent)
A	Member.....	8.0
B	Member.....	6.0
C	Nonmember.....	9.0
D	Nonmember.....	7.0
E-H	Members.....	4.5
I-M	Nonmembers.....	6.0

Employees A, B, C, and D are highly compensated.

(ii) For purposes of sections 410(b), 401(a)(4) and 401(k), the portion of T's plan covering collectively bargained unit members must be disaggregated from the portion covering other employees.

Employee	ADR (percent)
Collective Bargaining Unit Members:	
A.....	8.0
B.....	6.0
E-H.....	4.5
Other Employees:	
C.....	9.0
D.....	7.0
I-M.....	6.0

¹ Average.

(iii) The ADPs for the collectively bargained highly compensated group and nonhighly compensated group, respectively, are seven percent and 4.5 percent. The ADPs for the other highly compensated and nonhighly compensated employees, respectively, are eight percent and six percent.

(iv) The non-collectively bargained portion of the disaggregated plan satisfies the ADP test for the 1994 plan year, but the collectively bargained portion does not. Employer T is not required to make corrections to the collectively bargained portion of the cash or deferred arrangement, because a collectively bargained plan automatically satisfies the nondiscrimination requirements of 401(a)(4). However, unless Employer T corrects the ADP test failure in the collectively bargained portion of the plan, either by reducing A's ADR to seven percent or adding QNCs for the nonhighly compensated employees, all elective contributions made by collectively bargained

employees for the year will be includible in income in 1994.

(g) **Definitions.** The following definitions apply for purposes of this section, unless the context clearly indicates otherwise:

(1) **Actual deferral percentage—(i) General rule.** The actual deferral percentage for a group of employees for a plan year is the average of the actual deferral ratios of employees in the group for that plan year. For plan years that begin after December 31, 1988, or such later date provided in paragraph (h) of this section, actual deferral ratios and the actual deferral percentage for a group are calculated to the nearest hundredth of a percentage point.

(ii) **Actual deferral ratio—(A) General rule.** An employee's actual deferral ratio for the plan year is the sum of the employee's elective contributions and amounts treated as elective contributions for the plan year, divided by the employee's compensation taken into account for the plan year. If an eligible employee makes no elective contributions, and no qualified matching contributions or qualified nonelective contributions are taken into account with respect to the employee, the actual deferral ratio of the employee is zero. See paragraphs (b)(4), (b)(5), and (g)(2) of this section for rules regarding the elective contributions, qualified nonelective contributions, and compensation taken into account in calculating this fraction.

(B) **Employee eligible under more than one arrangement—(1) Highly compensated employees.** For plan years beginning after December 31, 1984, the actual deferral ratio of a highly compensated employee who is eligible to participate in more than one cash or deferred arrangement of the same employer is generally calculated by treating all the cash or deferred arrangements in which the employee is eligible to participate as one arrangement. However, plans that are not permitted to be aggregated under § 1.401(k)-1(b)(3)(ii)(B) are not aggregated for this purpose, except as specifically provided in § 1.401(m)-2(b)(1). For example, if a highly compensated employee with compensation of \$80,000 could make elective contributions under two separate cash or deferred arrangements, the actual deferral ratio for the employee under each arrangement would generally be calculated by dividing the total elective contributions by the employee under both arrangements by \$80,000. If one of the cash or deferred arrangements were part of an ESOP, however, while the other

was not, the actual deferral percentage of the employee under each arrangement would be calculated by dividing the employee's elective contributions under each arrangement by \$80,000 because the ESOP portion is mandatorily disaggregated from the non-ESOP portion.

(2) *Nonhighly compensated employees.* For plan years beginning after December 31, 1984, and before January 1, 1987 (or such later date provided under paragraph (h) of this section), this paragraph (g)(1)(ii)(B) applies to all employees, and not only to highly compensated employees.

(3) *Treatment of plans with different plan years.* If the cash or deferred arrangements that are treated as a single arrangement under this paragraph (g)(1)(ii)(B) are parts of plans that have different plan years, the cash or deferred arrangements are treated as a single arrangement with respect to the plan years ending with or within the same calendar year.

(C) *Employees subject to family aggregation rules—(1) Aggregation of elective contributions and other amounts.* For plan years beginning after December 31, 1986, or any later date provided in paragraph (h) of this section, if an eligible highly compensated employee is subject to the family aggregation rules of section 414(q)(6) because that employee is either a five-percent owner or one of the 10 most highly compensated employees, the combined actual deferral ratio for the family group (which is treated as one highly compensated employee) must be determined by combining the elective contributions, compensation, and amounts treated as elective contributions of all the eligible family members.

(2) *Effect on actual deferral percentage of nonhighly compensated employees.* The elective contributions, compensation, and amounts treated as elective contributions of all family members are disregarded for purposes of determining the actual deferral percentage for the group of nonhighly compensated employees.

(3) *Multiple family groups.* If an employee is required to be aggregated as a member of more than one family group in a plan, all eligible employees who are members of those family groups that include that employee are aggregated as one family group.

(2) *Compensation—(i) Years beginning after December 31, 1986.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (h) of this section, the term "compensation" means compensation as defined in section 414(s). The period

used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year for purposes of this section. An employer may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year for purposes of this section. See also section 401(a)(17).

(ii) *Years beginning before January 1, 1987—(A) General rule.* An employee's compensation for a plan year beginning before January 1, 1987, or such later date provided under paragraph (h) of this section, is the amount taken into account under the plan (or plans) in calculating the elective contribution that may be made on behalf of the employee. In a plan that is top-heavy (as defined in section 416), compensation may not exceed \$200,000. Compensation may not exclude amounts less than a stated amount, such as the integration level under the plan. Compensation may include all compensation for the plan year, including compensation for the period when an employee was ineligible to make a cash or deferred election.

(B) *Nondiscrimination requirement—(1) If the plan's definition of compensation has the effect of discriminating in favor of employees who are highly compensated, a nondiscriminatory definition shall be determined by the Commissioner.*

(2) *A plan's definition of compensation is treated as nondiscriminatory if the plan defines compensation for a plan year either as—*

(i) *an employee's total nondeferred compensation includible in gross income plus elective contributions under the plan and elective contributions under a plan described in section 125, and/or*

(ii) *an employee's W-2 or total nondeferred compensation includible in gross income.*

(3) *Elective contributions.* The term "elective contribution" means employer contributions made to a plan that were subject to a cash or deferred election under a cash or deferred arrangement (whether or not the arrangement is a qualified cash or deferred arrangement under paragraph (a)(4) of this section). No amount that has become currently available to an employee or that is designated or treated, at the time of deferral or contribution, as an after-tax employee contribution may be treated

as an elective contribution. See paragraphs (a)(2) and (a)(3) of this section. See also paragraph (a)(6)(iii) of this section for rules relating to the treatment as elective contributions of certain matching contributions made by partnerships.

(4) *Eligible employee—(i) General rule.* 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. For example, if an employee must perform purely ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make a cash or deferred election for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs the acts. An employee who is unable to make a cash or deferred election because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make a cash or deferred election for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. See paragraph (e)(5) of this section, however, for certain limits on the use of minimum service requirements. An employee who would be eligible to make elective contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(k)(3) for a plan year even though the employee may not make a cash or deferred election by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1) or 415(e).

(ii) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible to make a cash or deferred election under any arrangement of the employer, is given the one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make a cash or deferred election under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. This rule applies in addition to the rules in paragraphs

(a)(3)(iv) and (a)(6)(ii)(C) of this section relating to the definition of a cash or deferred election.

(5) *Employee.* The term "employee" means an individual who performs services for the employer who is either a common law employee of the employer, a self-employed individual who is treated as an employee pursuant to section 401(c)(1), or a leased employee who is treated as an employee of the employer-recipient pursuant to the provisions of section 414(n)(2) or section 414(o)(2), other than individuals who are excluded by reason of section 414(n)(5). Individuals that an employer treats as employees under section 414(n), pursuant to the requirements of section 414(o), are considered to be leased employees for purposes of this rule.

(6) *Employer.* The term "employer" means the employer maintaining the plan and those employers required to be aggregated with the employer under section 414 (b), (c), (m), or (o). An individual who owns the entire interest of an unincorporated trade or business is treated as an employer. Also, a partnership is treated as the employer of each partner and each employee of the partnership.

(7) *Excess contributions and excess deferrals—(i) Excess contributions.* The term "excess contribution" means, with respect to a plan year, the excess of the elective contributions, including qualified nonelective contributions and qualified matching contributions that are treated as elective contributions under paragraph (b)(2) of this section, on behalf of eligible highly compensated employees for the plan year over the maximum amount of the contributions permitted under paragraph (b)(2) of this section. The amount of excess contributions for each highly compensated employee is determined by using the method described in paragraph (f)(2) of this section.

(ii) *Excess deferrals.* The term "excess deferrals" means excess deferrals as defined in § 1.402(g)-1(e)(3).

(8) *Highly compensated employees—(i) Plan years beginning after December 31, 1986.* For plan years beginning after December 31, 1986, or such later date provided under paragraph (h) of this section, the term "highly compensated employee" has the meaning provided in section 414(q).

(ii) *Plan years beginning after December 31, 1979 and before January 1, 1987.* For plan years beginning after December 31, 1979, and before January 1, 1987, or such later date provided under paragraph (h) of this section, for purposes of the actual deferral percentage test, highly compensated employees are the one-third of all

eligible employees (rounded to the nearest integer) who receive the most compensation. When one or more employees of a group would be highly compensated employees except that each member of the group receives the same amount of compensation, the employer must designate which employees of the group are highly compensated, so that one-third of all eligible employees are considered highly compensated.

(9) *Matching contributions.* The term "matching contribution" means matching contributions as defined in § 1.401(m)-1(f)(12).

(10) *Nonelective contributions.* The term "nonelective contribution" means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

(11) *Plan—(i) General rule.* The term "plan" refers to a plan described in section 401(a) that includes one or more trusts intended to be exempt from tax under section 501(a) and to an annuity plan described in section 403(a). As described in paragraph (g)(11)(ii) of this section, each single plan under section 414(l) is to be treated as a single plan. Furthermore, as described in paragraph (g)(11)(iii) of this section certain single plans must be treated as comprising separate plans, each of which is a single plan.

(ii) *Separate asset pools are separate plans.* Each single plan within the meaning of section 414(l) is a separate plan. See § 1.414(l)-1(b). A single plan under section 414(l) is a single plan notwithstanding that the plan comprises separate written documents and separate trusts, each of which have received separate determination letters from the Internal Revenue Service. A plan does not comprise separate plans merely because it includes more than one trust or it provides for separate accounts and permits employees to direct the investment of the amounts allocated to their accounts. Further, a plan does not comprise separate plans merely because assets are separately invested in individual insurance or annuity contracts for employees.

(iii) *Mandatory disaggregation of certain plans—(A) Plans benefiting collective bargaining unit employees.* A plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are not included in such a collective bargaining unit is treated as comprising separate plans. This paragraph (g)(11)(iii)(A) is applied separately with respect to each

collective bargaining unit. Thus, for example, if a plan benefits employees in three categories—employees included in collective bargaining unit A, employees included in collective bargaining unit B, and employees who are not included in any collective bargaining unit—the plan is treated as comprising three separate plans, each of which benefits only one category of employees. Similarly, if a plan benefits only employees who are included in collective bargaining unit A and collective bargaining unit B, the plan is treated as comprising two separate plans.

(B) *ESOPs and non-ESOPs.* The portion of a plan that is an employee stock ownership plan described in section 4975(e) or 409 (an ESOP) and the portion of the plan that is not an ESOP are treated as separate plans, except as otherwise permitted under § 54.4975-11(e) of this chapter. Notwithstanding § 54.4975-11(a)(5) of this chapter, an employer may treat the rule in this paragraph (g)(11)(iii)(B) as not effective for plan years beginning before January 1, 1990.

(C) *Plans benefiting employees of qualified separate lines of business.* If an employer is treated as operating qualified separate lines of business for purposes of section 410(b), the portion of a plan that benefits employees of one qualified separate line of business is treated as a separate plan from the portions of the same plan that benefit employees of the other qualified separate lines of business of the employer.

(D) *Plans maintained by more than one employer—(1) Multiple employer plans.* If a plan benefits employees of more than one employer, and the employees are not included in a unit of employees covered by a collective bargaining agreement (a multiple employer plan), the plan is treated as comprising separate plans each of which is maintained by a separate employer.

(2) *Multiemployer plans.* The portion of a plan that benefits employees who are included in a collective bargaining unit, the portion of the plan that benefits employees who are included in another collective bargaining unit and the portion of the plan that benefits non-collective bargaining unit employees are all treated as separate plans. Consistent with section 413(b), the portion of the plan that is maintained pursuant to a collective bargaining agreement is treated as a single plan maintained by a single employer that employs all the employees benefiting under the same benefit computation formula and covered pursuant to that collective bargaining agreement. The

noncollectively bargained portion of the plan is treated as maintained by one or more employers, depending on whether the non-collective bargaining unit employees who benefit under the plan are employed by one or more employers.

(iv) *Mandatory aggregation of certain plans.* See §§ 1.401(k)-1(b)(3)(ii) and 1.401(m)-1(b)(3)(i) for additional rules requiring separate plans to be treated as a single plan in some cases.

(12) *Pre-ERISA money purchase pension plan*—(i) A pre-ERISA money purchase pension plan is a pension plan:

(A) That is a defined contribution plan (as defined in section 414(i));

(B) That was in existence on June 27, 1974, and as in effect on that date, included a salary reduction agreement described in paragraph (a)(3)(i) of this section; and

(C) Under which neither the employee contributions nor the employer contributions, including elective contributions, may exceed the levels (as a percentage of compensation) provided for by the contribution formula in effect on June 27, 1974.

(ii) A plan was in existence on June 27, 1974, if it was a written plan adopted on or before that date, even if no funds had yet been paid to the trust associated with the plan.

(13) *Qualified matching contributions and qualified nonelective contributions*—(i) *Qualified matching contributions.* The term "qualified matching contribution" means matching contributions that satisfy the additional requirements of paragraph (g)(13)(iii) of this section.

(ii) *Qualified nonelective contributions.* The term "qualified nonelective contribution" means employer contributions, other than elective contributions and matching contributions, that satisfy the additional requirements of paragraph (g)(13)(iii) of this section.

(iii) *Additional requirements.* Except to the extent that paragraphs (c) and (d) of this section specifically provide otherwise, the matching contributions and the nonelective contributions must satisfy the requirements of paragraphs (c) and (d) of this section as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account as elective contributions under paragraph (b)(2) of this section. Thus, the matching and nonelective contributions must satisfy the vesting requirements of paragraph (c) of this section and be subject to the distribution requirements of paragraph (d) of this section when they are contributed to the plan. See § 1.401(k)-1(f)(5)(iii) for rules regarding matching

contributions not treated as forfeitable under section 411(a)(3)(G) because of excess deferrals or contributions.

(14) *Rural cooperative plan.* For purposes of this section, a rural cooperative plan is a plan described in section 401(k).

(h) *Effective dates*—(1) *General rule.* Except as otherwise provided in this paragraph (h) or as specifically provided elsewhere in this section, this section applies to plan years beginning after December 31, 1979.

(2) *Collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986:

(i) The provisions of this section first effective for plan years beginning after December 31, 1986, do not apply to years that begin before the earlier of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986).

(ii) The provisions of this section first effective for plan years beginning after December 31, 1988, do not apply to years beginning before the earlier of:

(A) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986); or

(B) January 1, 1991.

(3) *Transition rules*—(i) *Cash or deferred arrangements in existence on June 27, 1974.* See § 1.402(a)-1(d)(3)(ii) for a transition rule applicable to cash or deferred arrangements in existence on June 27, 1974.

(ii) *Plan years beginning after December 31, 1979, and before January 1, 1992.* For plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1992, a reasonable interpretation of the rules set forth in section 401 (k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a cash or deferred arrangement was qualified during those years.

(iii) *Restructuring*—(A) *General rule.* In determining whether the requirements of section 401(k) is satisfied for plan years beginning before January 1, 1992, a plan may be treated as consisting of two or more component plans, each consisting of all of the allocations and other benefits, rights, and features provided to a group of employees under the plan. An employee may not be included in more than one component

plan of the same plan for a plan year under this method. If this method is used for a plan year, the requirements of section 401(k) is applied separately with respect to each component plan for the plan year. Thus, for example, the actual deferral ratio and the amount of excess contributions, if any, of each eligible employee under each component plan must be determined as if the component plan were a separate plan. This method applies solely for purposes of section 401(k). Thus, for example, the requirements of section 410(b) must still be satisfied by the entire plan.

(B) *Identification of component plans*—(1) *Minimum coverage requirement.* The group of eligible employees described in § 1.401(k)-1(g)(4) under each component plan must separately satisfy the requirements of section 410(b) as if the component plan were a separate plan. Component plans may not be aggregated to satisfy this requirement.

(2) *Commonality requirement.* The group of employees used to identify a component plan must share some common attribute or attributes, other than similar actual deferral ratios. Permissible common attributes include, for example, employment at the same work site, in the same job category, for the same division or subsidiary, or for a unit acquired in a specific merger or acquisition, employment for the same number of years, compensation under the same method (e.g., salaried or hourly), coverage under the same contributions formula, and attributes that could be used as the basis of a classification that would be treated as reasonable under the average benefit percentage test of section 410(b)(1)(C) and (b)(2). Employees whose only common attribute is the same or similar actual deferral ratios, or another attribute having substantially the same effect as the same or similar actual deferral ratios, are not considered as sharing a common attribute for this purpose. This rule applies regardless of whether the component plan or the plan of which it is a part satisfies the ratio or percentage test of section 410(b).

(4) *State and local government plans*—(i) *Plans adopted before May 6, 1986.* A plan adopted by a state or local government prior to May 6, 1986, is subject to the transitional rules of paragraph (h)(4) (ii) or (iii) of this section.

(ii) *Plan years beginning before January 1, 1993.* The following rules apply for plan years beginning before January 1, 1993, to a governmental plan described in section 414(d) that is not a collectively bargained plan and includes

a nonqualified cash or deferred arrangement:

(A) The plan does not fail to satisfy the requirements of section 401(a) merely because of the nonqualified cash or deferred arrangement.

(B) Employer contributions under the nonqualified cash or deferred arrangement are considered to satisfy the requirements of section 401(a)(4).

(C) Except as provided in paragraphs (a)(7) and (f) of this section, elective contributions under the arrangement are treated as employer contributions under the Internal Revenue Code of 1986, as if the arrangement were a qualified cash or deferred arrangement. See § 1.401(k)-1(a)(4)(ii). See § 1.402(a)-1(d) for rules governing when elective contributions under the arrangement are includible in an employee's gross income.

(iii) *Collectively bargained plans.* The transition rules in paragraph (h)(4)(ii) of this section apply to a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers and adopted by a state or local government before May 6, 1986, effective on the date the provisions of section 401(k) and this section would be effective under paragraph (h)(2) of this section.

Par. 4. New §§ 1.401(m)-0 through 1.401(m)-2 are added to read as follows:

§ 1.401(m)-0 Employee and matching contributions, table of contents.

This section contains the captions that appear in §§ 1.401(m)-1 and 1.401(m)-2.

§ 1.401(m)-1 Employee and matching contributions.

- (a) General rules.
 - (1) Nondiscriminatory amount of contributions.
 - (2) Other nondiscrimination rules.
 - (3) Rules applicable to collectively bargained plans.
- (b) Actual contribution percentage test.
 - (1) General rule.
 - (2) Plan provision requirement.
 - (3) Aggregation of plans.
 - (i) General rule.
 - (ii) Prohibited aggregation.
 - (iii) Restructuring.
 - (4) Employee and matching contributions taken into account under the actual contribution percentage test.
 - (i) Employee contributions.
 - (A) General rule.
 - (B) Recharacterized elective contributions.
 - (ii) Matching contributions.
 - (A) General rule.
 - (B) Matching contributions used to satisfy actual deferral percentage test.
 - (C) Treatment of forfeited matching contributions.
 - (5) Qualified nonelective contributions and elective contributions that may be taken into account under the actual contribution percentage test.

- (c) Additional requirements.
 - (1) Coordination with other plans.
 - (2) Recordkeeping requirement.
- (d) Examples.
- (e) Correction of excess aggregate contributions.
 - (1) General rule.
 - (i) Permissible correction methods.
 - (ii) Combination of correction methods.
 - (iii) Impermissible correction methods.
 - (iv) Partial correction.
 - (2) Amount of excess aggregate contributions.
 - (i) General rule.
 - (ii) Coordination with correction of excess contributions.
 - (iii) Correction of family members.
 - (3) Corrective distribution of excess aggregate contributions (and income).
 - (i) General rule.
 - (ii) Income allocable to excess aggregate contributions.
 - (A) General rule.
 - (B) Method of allocating income.
 - (C) Alternative method of allocating income.
 - (D) Safe harbor method of allocating gap period income.
 - (E) Allocable income for recharacterized elective contributions.
 - (iii) No employee or spousal consent required.
 - (iv) Treatment of corrective distributions and forfeited contributions as employer contributions.
 - (v) Tax treatment of corrective distributions.
 - (A) General rule.
 - (B) Rule for de minimis distributions.
 - (C) Rule for certain 1987 and 1988 excess aggregate contributions.
 - (vi) No reduction of required minimum distribution.
 - (4) Coordination with section 401(a)(4).
 - (5) Failure to correct.
 - (i) Failure to correct within 2½ months after end of plan year.
 - (ii) Failure to correct within 12 months after end of plan year.
 - (6) Examples.
- (f) Definitions.
 - (1) Actual contribution percentage.
 - (i) General rule.
 - (ii) Actual contribution ratio.
 - (A) General rule.
 - (B) Highly compensated employee eligible under more than one plan.
 - (C) Employees subject to family aggregation rules.
 - (1) Aggregation of employee contributions and other amounts.
 - (2) Effect on actual contribution percentage of nonhighly compensated employees.
 - (3) Multiple family groups.
 - (2) Compensation.
 - (3) Elective contributions.
 - (4) Eligible employee.
 - (i) General.
 - (ii) Certain one-time elections.
 - (5) Employee.
 - (6) Employee contributions.
 - (7) Employer.
 - (8) Excess aggregate contributions.
 - (9) Excess contributions.
 - (10) Excess deferrals.
 - (11) Highly compensated employee.

(12) Matching contributions.

- (i) In general.
- (ii) Employer contributions made on account of employee or elective contributions.
- (iii) Contributions used to meet the requirements of section 416.
- (13) Nonelective contributions.
- (14) Plan.
- (15) Qualified nonelective contributions.
- (g) Effective dates.
 - (1) General rule.
 - (2) Collectively bargained plans.
 - (3) Certain annuity contracts.
 - (4) State and local government plans.
 - (5) Transition rule for plan years beginning before 1992.
 - (i) General rule.
 - (ii) Restructuring.
 - (A) General rule.
 - (B) Identification of component plans.
 - (1) Minimum coverage requirement.
 - (2) Commonality requirement.

§ 1.401(m)-2 Multiple Use of alternative limitation.

- (a) In general.
- (b) General rule for determination of multiple use.
 - (1) In general.
 - (2) Alternative limitation.
 - (3) Aggregate limit.
 - (i) In general.
 - (ii) Relevant actual deferral percentage and relevant actual contribution percentage defined.
 - (iii) Examples.
- (c) Correction of multiple use.
 - (1) In general.
 - (2) Treatment of required reduction.
 - (3) Required reduction.
 - (4) Examples.
- (d) Effective date.
 - (1) General rule.
 - (2) Transition rule.

§ 1.401(m)-1 Employee and matching contributions.

(a) *General rules—(1) Nondiscriminatory amount of contributions.* A defined contribution plan does not satisfy section 401(a)(4) for a plan year unless the amount of employee and matching contributions to the plan for the plan year satisfies section 401(a)(4). Except as specifically provided otherwise, for plan years beginning after December 31, 1986, (or such later date provided in paragraph (g) of this section) the amount of employee and matching contributions under a plan satisfies the requirements of section 401(a)(4) only if the employee and matching contributions under the plan satisfy the actual contribution percentage test of section 401(m)(2) and paragraph (b) of this section. For this purpose, the employee and matching contributions are combined with the elective and qualified nonelective contributions, if any, that are treated as matching contributions, and the recharacterized elective contributions, if

any, that are treated as employee contributions for purposes of section 401(m).

(2) *Other nondiscrimination rules.* Nondiscrimination requirements in addition to those described in paragraph (a)(1) of this section apply to employee and matching contributions under section 401(a)(4). For example, under section 401(a)(4) a plan may not discriminate with respect to the availability of benefits, rights, and features under the plan. The right to make each level of employee contributions, and the right to each level of matching contributions, are benefits, rights, or features subject to this requirement, and each level must therefore generally be available to a group of employees that satisfies section 410(b). Thus, for example, a plan does not satisfy section 401(a)(4) if it provides a higher rate of matching contributions for highly compensated employees than for nonhighly compensated employees. See paragraph (e)(4) of this section for rules relating to the application of section 401(a)(4) to the correction of excess aggregate contributions.

(3) *Rules applicable to collectively bargained plans.* The requirements of this section are treated as satisfied by employee and matching contributions under a collectively bargained plan (or the portion of a plan) that automatically satisfies section 410(b).

(b) *Actual contribution percentage test*—(1) *General rule.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (g) of this section, the actual contribution percentage test is satisfied if:

(i) The actual contribution percentage for the group of eligible highly compensated employees is not more than the actual contribution percentage for the group of all other eligible employees multiplied by 1.25; or

(ii) The excess of the actual contribution percentage for the group of eligible highly compensated employees over the actual contribution percentage for the group of all other eligible employees is not more than two percentage points, and the actual contribution percentage for the group of eligible highly compensated employees is not more than the actual contribution percentage for the group of all other eligible employees multiplied by two.

(2) *Plan provision requirement.* For plan years beginning after December 31, 1986, or such later date provided in paragraph (g) of this section, a plan that permits employee or matching contributions does not satisfy the requirements of section 401(a) unless it provides that the actual contribution

percentage test of section 401(m)(2) will be met. For purposes of this paragraph (b)(2), the plan may incorporate the provisions of section 401(m)(2), this paragraph (b), and, if applicable, section 401(m)(9) and § 1.401(m)-2.

(3) *Aggregation of plans*—(i) *General rule.* Plans that are aggregated for purposes of section 410(b) (other than the average benefit percentage test) are treated as a single plan for purposes of section 401(m) and this section. For example, if an employer provides matching contributions under separate profit-sharing plans for its salaried and hourly employees, and treats them as a single plan for purposes of section 410(b), the plans are treated as a single plan for purposes of section 401(m) and this section. See also paragraph (f)(1)(ii) of this section for rules requiring the aggregation of contributions under two or more plans in computing the actual contribution ratios of highly compensated employees.

(ii) *Prohibited aggregation.* Section 410(b) provides the exclusive means of aggregating plans for purposes of this section. For example, allocations under a plan or portion of a plan described in section 4975(e)(7) or 409 (an ESOP) may not be combined with contributions or allocations under any plan or portion of a plan not described in section 4975(e)(7) or 409 (a non-ESOP) for purposes of determining whether either the ESOP or the non-ESOP satisfies the requirements of section 401(m). Similarly, in the case of a plan maintained by more than one employer to which section 413(c) applies, section 401(m) and this section must be applied as if each employer maintained a separate plan. Also, a plan covering both employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are not so covered must be treated as two separate plans (one for each group of eligible employees) for purposes of section 401(m). Further, two plans may not be aggregated unless they have the same plan year. In addition, plans that are not actually aggregated for a year for purposes of section 410(b) (other than the average benefit percentage test) may not be aggregated for purposes of this section.

(iii) *Restructuring.* Effective for plan years beginning after December 31, 1991, restructuring may not be used to demonstrate compliance with the requirements of section 401(m). For plan years beginning before January 1, 1992, see § 1.401(k)-1(h)(3)(iii).

(4) *Employee and matching contributions taken into account under the actual contribution percentage test*—(i) *Employee contributions*—(A)

General rule. An employee contribution is taken into account under paragraph (b)(1) of this section for the plan year in which the contribution is made to the trust. For this purpose, a payment by the employee to an agent of the plan is treated as a contribution to the trust at the time of payment to the agent if the funds paid are transmitted to the trust within a reasonable period after the payment to the agent.

(B) *Recharacterized elective contributions.* An excess contribution that is recharacterized under § 1.401(k)-1(f)(3) is taken into account as an employee contribution for the plan year that includes the time at which the excess contribution is includible in the gross income of the employee under § 1.401(k)-1(f)(3)(ii).

(ii) *Matching contributions*—(A) *General rule.* A matching contribution is taken into account under paragraph (b)(1) of this section for a plan year only if the contribution is allocated to the employee's account under the terms of the plan as of any date within the plan year, is actually paid to the trust no later than 12 months after the close of the plan year, and is made on behalf of an employee on account of the employee's elective contributions or employee contributions for the plan year. Matching contributions that do not satisfy these requirements are not taken into account under paragraph (b)(1) of this section for any plan year. Instead, the amount of these matching contributions must satisfy the requirements of section 401(a)(4) (without regard to the special nondiscrimination rule in paragraph (b)(1) of this section) for the plan year for which they are allocated under the plan, as if they were nonelective contributions and were the only nonelective employer contributions for that year.

(B) *Matching contributions used to satisfy actual deferral percentage test.* A matching contribution that is treated as an elective contribution is subject to the actual deferral percentage test of section 401(k)(3) and is not taken into account under paragraph (b)(1) of this section. See § 1.401(k)-1(b)(5)(iii) for the rule relating to years before January 1, 1987.

(C) *Treatment of forfeited matching contributions.* A matching contribution that is forfeited to correct excess aggregate contributions, or because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution, is not taken into account under paragraph (b)(1) of this section.

(5) *Qualified nonelective contributions and elective contributions that may be taken into account under the actual contribution percentage test.* Except as specifically provided otherwise, for purposes of paragraph (b)(1) of this section, all or part of the qualified nonelective contributions and elective contributions made with respect to any or all employees who are eligible employees under the plan of the employer being tested may be treated as matching contributions provided that each of the following requirements (to the extent applicable) is satisfied:

(i) The amount of nonelective contributions, including those qualified nonelective contributions treated as matching contributions for purposes of the actual contribution percentage test, satisfies the requirements of section 401(a)(4).

(ii) The amount of nonelective contributions, excluding those qualified nonelective contributions treated as matching contributions for purposes of the actual contribution percentage test and those qualified nonelective contributions treated as elective contributions under § 1.401(k)-1(b)(5) for purposes of the actual deferral percentage test, satisfies the requirements of section 401(a)(4).

(iii) The elective contributions, including those treated as matching contributions for purposes of the actual contribution percentage test, satisfy the requirements of section 401(k)(3).

(iv) The qualified nonelective contributions are allocated to the employee under the plan as of a date within the plan year (within the meaning of § 1.401(k)-1(b)(4)(i)(A)), and the elective contributions satisfy § 1.401(k)-1(b)(4)(i) for the plan year.

(v) For plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, the plan that takes qualified nonelective contributions and elective contributions into account in determining whether employee and matching contributions satisfy the requirements of section 401(m)(2)(A), and the plans to which the qualified nonelective contributions and elective contributions are made, are or could be aggregated for purposes of section 410(b) (other than the average benefit percentage test). If the plan year

of the plan being tested is changed to satisfy the requirement under section 410(b) that the aggregated plans have the same plan year, the elective contributions may be taken into account in the resulting short plan year only if these contributions satisfy the requirements of § 1.401(k)-1(b)(4) with respect to the short year, and the qualified nonelective contributions may be taken into account in the resulting short plan year only if these contributions satisfy the requirements of § 1.401(k)-1(b)(4)(i)(A) with respect to the short year as if they were elective contributions.

(c) *Additional requirements—(1) Coordination with other plans.* Except as expressly permitted under section 401(k) or 401(m), for plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, employee or matching contributions (or qualified nonelective or elective contributions treated as matching contributions under paragraph (b)(5) of this section) generally may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the employee or matching contributions are made) satisfy the requirements of section 401(a). Matching contributions and qualified nonelective contributions may be used to enable a plan to satisfy the minimum contribution or benefit requirements under section 416, but matching contributions that are used in this way generally may no longer be treated as matching contributions, and must therefore satisfy the nondiscrimination requirements of section 401(a)(4) without regard to section 401(k) or 401(m). See § 1.416-1, M-18 and M-19 and paragraph (f)(12)(iii) of this section. See also § 1.401(k)-1(b)(5) for circumstances under which matching contributions may be used to determine whether a plan satisfies the requirements of section 401(k). This paragraph does not apply for purposes of determining whether a plan satisfies the average benefit percentage test of section 410(b)(2)(A)(ii).

(2) *Recordkeeping requirement.* A plan satisfies this section only if the employer maintains the records necessary to demonstrate compliance

with the applicable nondiscrimination requirements of paragraph (b) of this section, including records showing the extent to which qualified nonelective contributions and elective contributions are taken into account.

(d) *Examples.* The provisions of paragraphs (a) through (c) of this section are illustrated by the following examples. Assume in each case that the employer is a corporation, and that the employer's taxable year and plan year are the calendar year. Also assume that the employee contributions, elective contributions, matching contributions and qualified nonelective contributions meet the applicable requirements of sections 401(a)(4) and 410. For methods to be used to correct excess aggregate contributions, see paragraph (e) of this section.

Example 1. (i) Employer L maintains a profit-sharing plan providing for voluntary employee contributions. L does not maintain a plan that includes a cash or deferred arrangement. For the 1988 plan year, the actual contribution percentages (ACPs) for the highly compensated employees and nonhighly compensated employees are shown in the following chart:

	Actual contribution percentage
Highly compensated	10
Nonhighly compensated	5

(ii) This plan fails to qualify under either of the tests of section 401(m)(2)(A) because the ACP for highly compensated employees is more than 125 percent of the ACP for nonhighly compensated employees, and exceeds the ACP for the nonhighly compensated employees by more than two percentage points. L must either reduce the ACP for the highly compensated employees to seven percent (to satisfy the 200 percent/two percentage point test) or increase the ACP of the nonhighly compensated employees to eight percent (to satisfy the 125 percent test).

Example 2. (i) Employer M maintains a plan under which each dollar of employee contributions is matched with \$.50 of employer contributions. M maintains no other plan. For the 1988 plan year, the average percentage of compensation contributed to the plan for the employees is shown in the following chart:

	Employee contributions (percent)	Matching contributions (percent)	Actual contribution percentage
Highly compensated	10	5	15
Nonhighly compensated	5	2.5	7.5

(ii) This plan fails to satisfy either of the tests of section 401(m)(2)(A). Employer M must either reduce the actual contribution percentage of the highly compensated employees to 9.5 percent (to satisfy the 200 percent/two percentage point test) or increase the actual contribution percentage of the nonhighly compensated employees to 12 percent (to satisfy the 125 percent test).

Example 3. (i) Employer N maintains a plan that contains a cash or deferred arrangement and permits employee contributions. For the 1988 plan year, the average percentages of compensation contributed to the plan by the highly compensated and nonhighly compensated employees as elective deferrals and employee contributions are shown in the chart below. Elective contributions meet the requirements of paragraph (b)(5) of this section.

	Elective contributions (percent)	Employee contributions (percent)
Highly compensated.....	10	10
Nonhighly compensated.....	10	6

(ii) The plan fails to meet the requirements of section 401(m) because the actual contribution percentage (ACP) of highly compensated employees is more than 125 percent of the ACP of the other employees, and exceeds the ACP of the other employees by more than two percentage points.

(iii) The plan provides that elective contributions made by nonhighly compensated employees may be used to meet the requirements of section 401(m) to the extent needed under that section. Under this provision, the plan uses elective contributions equal to two percent of the compensation of the nonhighly compensated employees in the ACP test. After this adjustment, the actual deferral percentages (ADPs) and ACPs are as follows:

	ADP (percent)	ACP (percent)
Highly compensated.....	10	10
Nonhighly compensated.....	8	8

(iv) The ACP of the highly compensated employees meets the requirements of section 401(m)(2)(A)(i) because it is 125 percent of

that for nonhighly compensated employees. The ADP of the highly compensated employees similarly satisfies the 125 percent test. The plan would also meet the requirements of section 401(m) if all elective contributions were used in the ACP test. This is because the ACP for the highly compensated employees (20 percent) would be 125 percent of the ACP for the nonhighly compensated employees (16 percent).

Example 4. (i) Employer P maintains a plan that includes a cash or deferred arrangement. Elective contributions, qualified nonelective contributions (QNCs), employee contributions, and matching contributions are made to the plan. The elective contributions and QNCs meet the requirements of paragraph (b)(5) of this section. For the 1989 plan year, the QNCs, elective contributions, and employee and matching contributions are shown in the following table:

	QNCs (percent)	Elective contributions (percent)	Employee/matching contributions (percent)
Highly compensated.....	3	5	6
Nonhighly compensated.....	3	4	2

(ii) The elective contributions meet the test of section 401(k)(3)(A)(ii). The employee and matching contributions, however, do not meet the actual contribution percentage (ACP) test. P may not use any QNCs of the nonhighly compensated employees to meet the ACP test because the remaining QNCs would discriminate in favor of the highly compensated employees. However, P could make additional QNCs or matching contributions of two percent of compensation on behalf of the nonhighly compensated employees. Alternatively, P could treat all

QNCs for all employees and elective contributions equal to one percent of compensation for nonhighly compensated employees as matching contributions and make additional QNCs of 1.2 percent of compensation on behalf of nonhighly compensated employees. The ACPs for highly and nonhighly compensated employees would then be nine percent and 7.2 percent, respectively, thus satisfying the 125 percent test. The actual deferral percentages would be five and three percent, respectively, which

would satisfy the 200 percent/two percentage point test.

Example 5. (i) Employer P maintains a cash or deferred arrangement. Elective contributions, qualified nonelective contributions (QNCs), employee contributions, and matching contributions are made to the plan. The elective contributions and the QNCs meet the requirements of paragraph (b)(5) of this section. For the 1989 plan year, the contributions are shown in the following table:

	QNCs (percent)	Elective contributions (percent)	Employee/matching contributions (percent)
Highly compensated.....	0	6	6
Nonhighly compensated.....	3	3	3

(iii) The QNCs may be used in the actual deferral percentage (ADP) test, the actual contribution percentage (ACP) test, or a combination of the two. If P treats one-third of the QNCs as elective contributions and two-thirds as matching contributions, the ADPs for the highly compensated and nonhighly compensated employees are six and four percent, respectively, and satisfy the 200 percent/two percentage point test. Similarly, the ACPs for the two groups are six

and five percent, respectively, and satisfy the 125 percent test.

(e) *Correction of excess aggregate contributions—(1) General rule—(i) Permissible correction methods.* A plan satisfies the requirements of section 401(m)(2) and paragraph (b)(1) of this section with respect to the amount of employee and matching contributions under the plan if the employer, in

accordance with the terms of the plan and paragraph (b)(5) of this section, makes qualified nonelective contributions or elective contributions that, in combination with employee and matching contributions, satisfy the actual contribution percentage test. In addition, a plan subject to the requirements of section 401(m) satisfies section 401(m)(2) and paragraph (b)(1) of

this section if, in accordance with the terms of the plan, excess aggregate contributions on behalf of highly compensated employees (and the income allocable to these contributions) are distributed in accordance with paragraph (e)(3) of this section. Matching contributions (and the income allocable to matching contributions) that are not vested (determined without regard to any increase in vesting that may occur after the date of the forfeiture) may also be forfeited to correct excess aggregate contributions. Finally, a plan may limit employee or matching contributions in a manner that prevents excess aggregate contributions from being made.

(ii) *Combination of correction methods.* The plan may permit a combination of the methods listed in paragraph (e)(1)(i) of this section to avoid or correct excess aggregate contributions.

(iii) *Impermissible correction methods.* Excess aggregate contributions may not be corrected by forfeiting vested matching contributions, recharacterizing matching contributions, or not making matching contributions required under the terms of the plan. Excess aggregate contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. See paragraph (e)(5) of this section for the effect of a failure to correct excess aggregate contributions. See § 1.411(a)-4(b)(7) regarding permissible forfeitures of matching contributions.

(iv) *Partial correction.* Any distribution of less than the entire amount of excess aggregate contributions (and income) is treated as a pro rata distribution of excess aggregate contributions and income.

(2) *Amount of excess aggregate contributions—(i) General rule.* The amount of excess aggregate contributions for a highly compensated employee for a plan year is the amount (if any) by which the employee's employee and matching contributions must be reduced for the employee's actual contribution ratio to equal the highest permitted actual contribution ratio under the plan. To calculate the highest permitted actual contribution ratio under a plan, the actual contribution ratio of the highly compensated employee with the highest actual contribution ratio is reduced by the amount required to cause the employee's actual contribution ratio to equal the ratio of the highly compensated employee with the next highest actual contribution ratio. If a lesser reduction would enable the

arrangement to satisfy the actual contribution percentage test, only this lesser reduction may be made. This process must be repeated until the plan satisfies the actual contribution percentage test. The highest actual contribution ratio remaining under the plan after leveling is the highest permitted actual contribution ratio. For each highly compensated employee, the amount of excess aggregate contributions for a plan year is equal to the total employee and matching contributions, plus qualified nonelective contributions and elective contributions taken into account in determining the employee's actual contribution ratio under paragraph (f)(1) of this section, minus the amount determined by multiplying the employee's actual contribution ratio (determined after application of this paragraph (e)(2)) by the compensation used in determining the ratio. In no case may the amount of excess aggregate contributions with respect to any highly compensated employee exceed the amount of employee and matching contributions made on behalf of the highly compensated employee for the plan year.

(ii) *Coordination with correction of excess contributions.* The amount of excess aggregate contributions with respect to an employee for a plan year is calculated after determining the excess contributions to be recharacterized as employee contributions for the plan year.

(iii) *Correction of family members.* The determination and correction of excess aggregate contributions of a highly compensated employee whose actual contribution ratio is determined under the family aggregation rules of paragraph (f)(1)(ii)(C) of this section, is accomplished by reducing the actual contribution ratio as required under this paragraph (e)(2) and allocating the excess aggregate contributions for the family group among the family members in proportion to the employee and matching contributions of each family member that are combined to determine the actual contribution ratio.

(3) *Corrective distribution of excess aggregate contributions (and income)—*

(i) *General rule.* Excess aggregate contributions (and income allocable thereto) are distributed in accordance with this paragraph (e)(3) only if the excess aggregate contributions and allocable income are designated by the employer as a distribution of excess aggregate contributions (and income), and are distributed to the appropriate highly compensated employees after the close of the plan year in which the excess aggregate contributions arose

and within 12 months after the close of that plan year. In the event of a complete termination of the plan during the plan year in which an excess aggregate contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of a highly compensated employee is distributed during the plan year in which the excess aggregate contribution arose, the distribution is deemed to have been a corrective distribution of excess aggregate contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(ii) *Income allocable to excess aggregate contributions—(A) General rule.* The income allocable to excess aggregate contributions is equal to the sum of the allocable gain or loss for the plan year and, if the plan so provides, the allocable gain or loss for the period between the end of the plan year and the date of distribution (the "gap period").

(B) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess aggregate contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts.

(C) *Alternative method of allocating income.* A plan may allocate income to excess aggregate contributions by multiplying the income for the plan year (and the gap period, if the plan so provides) allocable to employee contributions, matching contributions, and amounts treated as matching contributions by a fraction. The numerator of the fraction is the excess aggregate contributions for the employee for the plan year. The denominator of the fraction is equal to the sum of:

(1) The total account balance of the employee attributable to employee and matching contributions, and amounts treated as matching contributions as of the beginning of the plan year; plus

(2) The employee and matching contributions, and amounts treated as matching contributions for the plan year and for the gap period if gap period income is allocated.

(D) *Safe harbor method of allocating gap period income.* Under the safe harbor method, income on excess aggregate contributions for the gap period is equal to 10 percent of the

income allocable to excess aggregate contributions for the plan year (calculated under the method described in paragraph (e)(3)(ii)(C) of this section), multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(E) *Allocable income for recharacterized elective contributions.* If recharacterized elective contributions are distributed as excess aggregate contributions, the income allocable to the excess aggregate contributions is determined as if recharacterized elective contributions had been distributed as excess contributions. Thus, income must be allocated to the recharacterized amounts distributed using the methods in § 1.401(k)-1(f)(4)(ii).

(iii) *No employee or spousal consent required.* A distribution of excess aggregate contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(iv) *Treatment of corrective distributions and forfeited contributions as employer contributions.* Excess aggregate contributions, including forfeited matching contributions, are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan. Forfeited matching contributions that are reallocated to the accounts of other participants for the plan year in which the forfeiture occurs are treated under section 415 as annual additions for the participants to whose accounts they are reallocated and for the participants from whose accounts they are forfeited.

(v) *Tax treatment of corrective distributions—(A) General rule.* Except as otherwise provided in this paragraph (e)(3)(v), a corrective distribution of excess aggregate contributions (and income) that is made within 2½ months after the end of the plan year for which the excess aggregate contributions were made is includible in the employee's gross income for the taxable year of the employee ending with or within the plan year for which the excess aggregate contributions were made. A corrective distribution of excess aggregate contributions (and income) that is made

more than 2½ months after the plan year for which the excess aggregate contributions were made is includible in the employee's gross income in the taxable year of the employee in which distributed. The portion of the distribution that is treated as an investment in the contract under section 72 is determined without regard to any plan contributions other than those distributed as excess aggregate contributions. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A. See paragraph (e)(5) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year.

(B) *Rule for de minimis distributions.* If the total excess contributions and excess aggregate contributions distributed to a recipient under a plan for any plan year are less than \$100 (excluding income), a corrective distribution of excess aggregate contributions (and income) is includible in gross income in the recipient's taxable year in which the corrective distribution is made.

(C) *Rule for certain 1987 and 1988 excess aggregate contributions.* Distributions for plan years beginning in 1987 and 1988 to which the de minimis rule of this paragraph (e)(3)(v) of this section would otherwise apply may be reported by the recipient, at the recipient's option, either in the year described in paragraph (e)(3)(v)(A) of this section, or in the year described in paragraph (e)(3)(v)(B) of this section. This special rule may be used only for distributions made within 2½ months after the close of the plan year, but not later than April 17, 1989.

(vi) *No reduction of required minimum distribution.* A distribution of excess aggregate contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9).

(4) *Coordination with section 401(a)(4).* The method of distributing excess aggregate contributions provided in the plan must satisfy the requirements of section 401(a)(4). This requires that after correction each level of matching contributions be effectively available to a group of employees that satisfies section 410(b). Thus, a plan under which employee contributions are distributed under this paragraph (e) to highly

compensated employees to the extent needed to meet the requirements of section 401(m)(2), while matching contributions attributable to employee contributions remain allocated to the highly compensated employees' accounts does not meet the requirements of section 401(a)(4). A method of distributing excess aggregate contributions will not be considered discriminatory solely because, in accordance with the terms of the plan, unmatched employee contributions that exceed the highest rate at which employee contributions are matched are distributed before matched employee contributions, or matching contributions are distributed (or forfeited) prior to employee contributions. See Example 6 in paragraph (e)(6) of this section.

(5) *Failure to correct—(i) Failure to correct within 2½ months after end of plan year.* If a plan does not correct excess aggregate contributions within 2½ months after the close of the plan year for which the excess aggregate contributions are made, the employer will be liable for a 10 percent excise tax on the amount of the excess aggregate contributions. See section 4979 and § 54.4979-1. Qualified nonelective contributions properly taken into account under paragraph (b)(5) of this section for a plan year may enable a plan to avoid having excess aggregate contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year.* If excess aggregate contributions are not corrected within 12 months after the close of the plan year for which they were made, the plan will fail to meet the requirements of section 401(a)(4) for the plan year for which the excess aggregate contributions were made and all subsequent plan years in which the excess aggregate contributions remain in the plan.

(6) *Examples.* The principles of this paragraph (e) are illustrated by the following examples. Assume in each example that no income or loss is allocable to elective, employee, or matching contributions.

Example 1. (i) Employer A maintains a thrift plan that does not include a cash or deferred arrangement. In 1990, the actual contribution percentage (ACP) for nonhighly compensated employees is four percent. Thus, the ACP for the group of highly compensated employees may not exceed six percent. The three highly compensated employees who participate have the following compensation, contributions, and actual contribution ratios (ACRs):

Employee	Compensation	Employee and matching contributions	Actual contribution ratio (percent)
A	100,000	10,000	10
B	90,000	6,300	7
C	75,000	3,750	5
Average			7.33

(ii) The maximum amount of employee and matching contributions permitted on behalf of A, B, and C is determined by reducing contributions in order of their ACRs, beginning with the highest ACR. Thus, A's contribution is first reduced to \$7,000 or 7.0 percent. Since the resulting ACP of 6.33 percent still exceeds the permitted highly compensated ACP of six percent, the contributions allocated to A and B must be further reduced to 6.5 percent. This results in an ACP of six percent, which meets the 200 percent/two percentage point test. The excess aggregate contributions for A and B are \$3,500 and \$450, respectively.

Example 2. Employee A is the sole highly compensated, participant in a cash or deferred arrangement maintained by Employer X. The plan that includes the arrangement, Plan X, provides a fully vested matching contribution equal to 50 percent of elective and employee contributions. Plan X is a calendar year plan. Plan X corrects excess contributions by recharacterization. For the 1988 plan year, A's compensation is \$58,333, and A's elective contributions are \$7,000. The actual deferral percentages and actual contribution percentages of A and other employees under Plan X are shown below:

	Actual deferral percentage	Actual contribution percentage
Employee A	12	6
Nonhighly compensated	8	4

(ii) In February 1989, Employer X determines that A's actual deferral ratio must be reduced to 10 percent, or \$5,833, which requires a recharacterization of \$1,167 as an employee contribution. This increases A's actual contribution ratio to eight percent (\$3,500 in matching contributions plus \$1,167 in employee contributions, divided by \$58,333 in compensation). Since A's actual contribution ratio must be limited to six percent for Plan X to satisfy the actual contribution percentage test, Plan X must distribute \$1,167 of A's employee and matching contributions.

Example 3. Same as *Example 2*, except that in 1988 A also had elective contributions of \$1,313 under Plan Y, maintained by an employer unrelated to X. In January 1989, A requests and receives a distribution of \$1,000 in excess deferrals from Plan X. A forfeits the \$500 match on the excess deferrals. The \$1,167 that would otherwise have been recharacterized for Plan X to satisfy the actual deferral percentage test is reduced by

the \$1,000 already distributed as an excess deferral, leaving \$167 to be recharacterized. A's actual contribution ratio is now 5.43 percent (\$3,000 in matching contributions plus \$167 in employee contributions, divided by \$58,333 in compensation). Since Plan X satisfies the actual contribution percentage test, no further distribution is required or permitted.

Example 4. Same as *Example 3*, except that A does not request a distribution of excess deferrals until March 1989. Employer X has already recharacterized \$1,167 as employee contributions, and distributed it as an excess aggregate contribution (see *Example 1*). Because the amount distributed is greater than the excess deferrals, A is not entitled to a distribution of excess deferrals.

Example 5. For the 1987 plan year, Employee B defers \$7,000 under Plan C and \$1,000 under plan D. Plans C and D are maintained by unrelated employers; both Plans C and D have calendar plan years. Plan C provides a fully vested, 100 percent matching contribution and does not take elective contributions into account under section 401(m) or take matching contributions into account under section 401(k). B timely requests and receives a distribution of the \$1,000 excess deferral from Plan C, and forfeits the corresponding matching contribution. Employer C subsequently determines that B has excess contributions of \$600 and excess aggregate contributions of \$600. Plan C provides that excess amounts are corrected by distribution. No distribution is required or permitted to correct the excess contributions because \$1,000 has been distributed from this plan as excess deferrals. The distribution required to correct the excess aggregate contributions is \$600. If B had corrected the excess deferrals of \$1,000 by withdrawing \$1,000 from Plan D, Plan C would have had to correct the \$600 excess contributions in Plan C by distributing \$600. Since B would have forfeited \$600 (instead of \$1,000) in matching contributions, B would have had \$1,200 of excess aggregate contributions in Plan C. These would have been corrected by distributing an additional \$1,200 from Plan C.

Example 6. Employee B is the sole highly compensated employee in a thrift plan under which the employer matches 100 percent of employee contributions up to two percent of compensation, and 50 percent of employee contributions up to the next four percent of compensation. For the 1988 plan year, B has compensation of \$100,000. B makes an employee contribution of \$7,000, or seven percent, and receives a four percent matching contribution of \$4,000. Thus, B's actual contribution ratio (ACR) is 11 percent. The actual contribution percentage for the nonhighly compensated employees is five

percent, and the employer determines that B's ACR must be reduced to seven percent to comply with the rules of section 401(m). In this case, the plan satisfies the requirements of this paragraph if it distributes the unmatched employee contributions of \$1,000, and \$2,000 of matched employee contributions with their related matches of \$1,000. This would leave B with four percent employee contributions, and three percent matching contributions, for an ACR of seven percent. The plan could instead distribute all matching contributions. The plan would fail to meet the requirements of this paragraph if it distributed \$4,000 (four percent) of B's employee contributions and none of B's matching contributions. See §§ 1.401(m)-1(e)(2) and 1.401(m)-1(e)(4).

Example 7. (i) Employee C is a highly compensated employee in Employer X's thrift plan, which matches 100 percent of employee contributions up to five percent of compensation. The matching contribution is vested at the rate of 20 percent per year. In 1991, C makes \$5,000 in employee contributions and receives \$5,000 of matching contributions. C is 60 percent vested in the matching contributions at the end of the 1991 plan year.

(ii) In February 1992, X determines that C has excess aggregate contributions of \$1,000. The plan provides that only matching contributions will be distributed as excess aggregate contributions.

(iii) X has two options available in distributing C's excess contributions. The first option is to distribute \$600 of vested matching contributions and forfeit \$400 of nonvested matching contributions. These amounts are in proportion to C's vested and nonvested interests in all matching contributions. The second option is to distribute \$1,000 of vested matching contributions, leaving the nonvested matching contributions in the plan.

(iv) If the second option is chosen, the plan must also provide a separate vesting schedule for vesting these nonvested matching contributions. This is necessary because the nonvested matching contributions must vest as rapidly as they would have had no distribution been made. Thus, 50 percent must vest in each of the next two years.

(v) The plan will not satisfy the nondiscriminatory availability requirement of section 401(a)(4) if only nonvested matching contributions are distributed because the effect is that matching contributions for highly compensated employees vest more rapidly than those for nonhighly compensated employees. See § 1.401(m)-1(e)(4).

(f) *Definitions.* The following definitions apply for purposes of this section and § 1.401(m)-2 except as otherwise specifically provided:

(1) *Actual contribution percentage—*

(i) *General rule.* The actual contribution percentage for a group of employees for a plan year is the average of the actual contribution ratios of the employees in the group. For plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, actual contribution ratios and the actual contribution percentage for a group are calculated to the nearest one-hundredth of a percentage point.

(ii) *Actual contribution ratio—(A)*

General rule. An employee's actual contribution ratio is the sum of the employee and matching contributions allocated to the employee's account for the plan year, and the qualified nonelective and elective contributions treated as matching contributions for the plan year, divided by the employee's compensation for the plan year. If an eligible employee makes no employee contributions and no matching, qualified nonelective contributions, or elective contributions are taken into account with respect to the employee, the actual contribution ratio of the employee is zero. See paragraphs (b)(4), (b)(5), and (f)(2) of the section for rules regarding the employee and matching contributions, qualified nonelective and elective contributions, and compensation that are taken into account in calculating this fraction.

(B) *Highly compensated employee eligible under more than one plan.* The actual contribution ratio of a highly compensated employee who is eligible to participate in more than one plan of an employer to which employee or matching contributions are made is calculated by treating all the plans in which the employee is eligible to participate as one plan. However, plans that are not permitted to be aggregated under § 1.401(m)-1(b)(3)(ii) are not aggregated for this purpose. For example, if a highly compensated employee with compensation of \$80,000 may receive matching contributions under two plans, the employee's actual contribution ratio under each plan is calculated by dividing the employee's total matching contributions under both plans by \$80,000, unless the plans are required to be disaggregated. In that case, the actual contribution ratio of the employee under each plan is to be calculated by dividing the employee's matching contributions under that plan by \$80,000. See paragraph (b)(3) of this section for the treatment of certain multiple plans. For plan years beginning

after December 31, 1988, or such later date provided in paragraph (g) of this section, if a highly compensated employee participates in two or more plans that have different plan years, this paragraph (f)(1)(ii) is applied by treating all plans whose plan years end with or within the same calendar year as a single plan.

(C) *Employees subject to family aggregation rules—(1) Aggregation of employee contributions and other amounts.* For plan years beginning after December 31, 1988, or such later date provided in paragraph (g) of this section, if a highly compensated employee is subject to the family aggregation rules of section 414(q)(6) because that employee is either a five-percent owner or one of the 10 most highly compensated employees, the combined actual contribution ratio for the family group (treated as one highly compensated employee) must be determined by combining the employee contributions, matching contributions, amounts treated as matching contributions, and compensation of all the eligible family members.

(2) *Effect on actual contribution percentage of nonhighly compensated employees.* The employee and matching contributions, amounts treated as matching contributions, and compensation of all family members are disregarded for purposes of determining the actual contribution percentage for the group of highly compensated employees, and the group of nonhighly compensated employees.

(3) *Multiple family groups.* If an employee is required to be aggregated as a member of more than one family group in a plan, all eligible employees who are members of those family groups that include that employee are aggregated as one family group.

(2) *Compensation.* The term "compensation" means compensation as defined in § 1.401(k)-1(g)(2).

(3) *Elective contributions.* The term "elective contribution" means elective contribution as defined in § 1.401(k)-1(g)(3).

(4) *Eligible employee—(i) General rule.* The term "eligible employee" means an employee who is directly or indirectly eligible to make an employee contribution or to receive an allocation of matching contributions (including matching contributions derived from forfeitures) under the plan for a plan year. For example, if an employee must perform ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make an employee contribution for a plan year, the

employee is an eligible employee for the plan year without regard to whether the employee performs these acts. An employee who is unable to make an employee contribution or to receive an allocation of matching contributions because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make an employee contribution or to receive an allocation of matching contributions for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. An employee who would be eligible to make employee contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is an eligible employee for purposes of section 401(m) for a plan year even though the employee may not make an employee contribution or receive an allocation of matching contributions by reason of the suspension. Finally, an employee does not fail to be an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1) or 415(e).

(ii) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible under any plan of the employer providing for employee or matching contributions, is given a one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make employee contributions or to receive allocations of matching contributions under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer.

(5) *Employee.* The term "employee" means an employee as defined in § 1.401(k)-1(g)(5).

(6) *Employee contributions.* The term "employee contribution" means any mandatory or voluntary contribution to the plan that is treated at the time of contribution as an after-tax employee contribution (e.g., by reporting the contribution as taxable income subject to applicable withholding requirements) and is allocated to a separate account to which the attributable earnings and losses are allocated. See § 1.401(k)-1(a)(2)(ii). The term includes:

(i) Employee contributions to the defined contribution portion of a plan described in section 414(k);

(ii) Employee contributions to a qualified cost-of-living arrangement described in section 415(k)(2)(B);

(iii) Employee contributions applied to the purchase of whole life insurance protection or survivor benefit protection under a defined contribution plan;

(iv) Amounts attributable to excess contributions within the meaning of section 401(k)(8)(B) that are recharacterized as employee contributions; and

(v) Employee contributions to an annuity contract described in section 403(b).

The term does not include repayment of loans, repayment of distributions described in section 411(a)(7)(C), or employee contributions that are transferred to a plan from another plan. For purposes of this paragraph (f)(6), employee contributions described in paragraph (f)(6)(ii) of this section are deemed contributed to a defined contribution plan.

(7) *Employer.* The term "employer" means the employer as defined in § 1.401(k)-1(g)(6).

(8) *Excess aggregate contributions.* The term "excess aggregate contribution" means, with respect to any plan year, the excess of the aggregate amount of the employee and matching contributions (and any qualified nonelective contribution or elective deferral taken into account in computing the contribution percentage) actually made on behalf of highly compensated employees for the plan year, over the maximum amount of contributions permitted under the limitations of section 401(m)(2)(A). The amount of excess aggregate contributions for each highly compensated employee is determined by using the method described in paragraph (e)(2) of this section. For purposes of this paragraph, qualified matching contributions treated as elective contributions in accordance with § 1.401(k)-1(b)(5) are disregarded.

(9) *Excess contributions.* The term "excess contribution" means an excess contribution as defined in § 1.401(k)-1(g)(7)(i).

(10) *Excess deferrals.* The term "excess deferrals" means excess deferral as defined in § 1.402(g)-1(e)(1)(iii).

(11) *Highly compensated employee.* The term "highly compensated employee" means a highly compensated employee as defined in section 414(q).

(12) *Matching contributions.*—(i) *In general.* The term "matching contribution" means:

(A) Any employer contribution (including a contribution made at the employer's discretion) to a defined

contribution plan on account of an employee contribution to a plan maintained by the employer;

(B) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an elective contribution to a plan maintained by the employer; and

(C) Any forfeiture allocated on the basis of employee contributions, matching contributions, or elective contributions.

(ii) *Employer contributions made on account of employee or elective contributions.* For purposes of paragraphs (f)(12)(i) of this section, whether an employer contribution is made on account of an employee contribution or an elective contribution is determined on the basis of all relevant facts and circumstances, including the relationship between the employer contribution and employee actions outside the plan. Thus, for example, an employer contribution made to a defined contribution plan on account of contributions made by an employee under an employer-sponsored savings arrangement that are not held in a plan that is described in § 1.402(g)-1(b) is not a matching contribution.

Notwithstanding the foregoing, for plan years beginning before January 1, 1992, an employer may elect to take into account as matching contributions, contributions made to a plan pursuant to an arrangement under which the employer makes contributions to the plan on account of either employee contributions to the plan or contributions made by an employee to an employer-sponsored savings arrangement that are not held in the plan, provided that the arrangement was in effect prior to August 8, 1988.

(iii) *Contributions used to meet the requirements of section 416.* For plan years beginning after December 31, 1988, a contribution or allocation that is used to meet the minimum contribution or benefit requirement of section 416 is not treated as made on account of an employee or elective contribution and therefore is not a matching contribution.

(13) *Nonelective contributions.* The term "nonelective contribution" means nonelective contributions as defined in § 1.401(k)-1(g)(10).

(14) *Plan.* The term "plan" means a plan as defined in § 1.401(k)-1(g)(11).

(15) *Qualified nonelective contributions.* The term "qualified nonelective contribution" means qualified nonelective contributions as defined in § 1.401(k)-1(g)(13)(ii).

(g) *Effective dates.*—(1) *General rule.* Except as provided in paragraphs (g)(2), (g)(3), (g)(4), and (g)(5) of this section, or

as specifically provided otherwise in this section, this section is effective for plan years beginning after December 31, 1986.

(2) *Collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, this section does not apply to years beginning before the earlier of—

(i) January 1, 1989, or

(ii) The date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after February 28, 1986).

(3) *Certain annuity contracts.*—(i) In the case of an annuity contract under section 403(b), not maintained pursuant to a collective bargaining agreement, except as otherwise provided in paragraph (g)(5) of this section, this section applies to plan years beginning after December 31, 1988.

(ii) In the case of an annuity contract described in section 403(b) maintained pursuant to a collective bargaining agreement described in paragraph (g)(2)(i) of this section, this section does not apply to years beginning before the earlier of

(A) The later of—

(1) January 1, 1989, or

(2) The date determined under paragraph (g)(2)(ii) of this section; or

(B) January 1, 1991.

(4) *State and local government plans.* A governmental plan described in section 414(d) is treated as satisfying section 401(m) for plan years beginning before January 1, 1993.

(5) *Transition rule for plan years beginning before 1992.*—(i) *General rule.* For plan years beginning before January 1, 1992, a reasonable interpretation of the rules set forth in section 401 (k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a plan was qualified during those years.

(ii) *Restructuring.*—(A) *General rule.* In determining whether the requirements of section 401(m) are satisfied for plan years beginning before January 1, 1992, a plan may be treated as consisting of two or more component plans, each consisting of all of the allocations and other benefits, rights, and features provided to a group of employees under the plan. An employee may not be included in more than one component plan of the same plan for a plan year under this method. If this method is used for a plan year, the requirements of section 401(m) are applied separately with respect to each component plan for

the plan year. Thus, for example, the actual contribution ratio and the amount of excess aggregate contributions, if any, of each eligible employee under each component plan must be determined as if the component plan were a separate plan. This method applies solely for purposes of section 401(m). Thus, for example, the requirements of section 410(b) must still be satisfied by the entire plan.

(B) *Identification of component plans*—(1) *Minimum coverage requirement.* The group of eligible employees described in § 1.401(m)-1(f)(4) under each component plan must separately satisfy the requirements of section 410(b) as if the component plan were a separate plan. Component plans may not be aggregated to satisfy this requirement.

(2) *Commonality requirement.* The group of employees used to identify a component plan must share some common attribute or attributes, other than similar actual contribution ratios. Permissible common attributes include, for example, employment at the same work site, in the same job category, for the same division or subsidiary, or for a unit acquired in a specific merger or acquisition, employment for the same number of years, compensation under the same method (e.g., salaried or hourly), coverage under the same contributions formula, and attributes that could be used as the basis of a classification that would be treated as reasonable under the average benefit percentage test of section 410(b)(1)(C) and (b)(2). Employees whose only common attribute is the same or similar actual contribution ratios, or another attribute having substantially the same effect as the same or similar actual contribution ratios, are not considered as sharing a common attribute for this purpose. This rule applies regardless of whether the component plan or the plan of which it is a part satisfies the ratio or percentage test of section 410(b).

§ 1.401(m)-2 Multiple use of alternative limitation.

(a) *In general.* The rules in this section prevent the multiple use of the alternative methods of compliance with sections 401(k) and (m) contained in section 401(k)(3)(A)(ii)(II) and 401(m)(2)(A)(ii) respectively. Paragraph (b) of this section discusses the scope of this section and contains the general rule for determination of a multiple use of the alternative limitation. Paragraph (c) of this section contains rules for the correction of multiple use.

(b) *General rule for determination of multiple use*—(1) *In general.* Multiple use of the alternative limitation occurs if

all of the conditions of this paragraph (b)(1) are satisfied:

(i) One or more highly compensated employees of the employer are eligible employees in both a cash or deferred arrangement subject to section 401(k) and a plan maintained by the employer subject to section 401(m).

(ii) The sum of the actual deferral percentage of the entire group of eligible highly compensated employees under the arrangement subject to section 401(k) and the actual contribution percentage of the entire group of eligible highly compensated employees under the plan subject to section 401(m) exceeds the aggregate limit of paragraph (b)(3) of this section.

(iii) The actual deferral percentage of the entire group of eligible highly compensated employees under the arrangement subject to section 401(k) exceeds the amount described in section 401(k)(3)(A)(ii)(1).

(iv) The actual contribution percentage of the entire group of eligible highly compensated employees under the arrangement subject to section 401(m) exceeds the amount described in section 401(m)(2)(A)(i).

The actual deferral percentage and actual contribution percentage of the group of eligible highly compensated employees are determined after use of qualified nonelective contributions and qualified matching contributions to meet the requirements of section 401(k)(3)(A)(ii) and after use of qualified nonelective contributions and elective contributions to meet the requirements of section 401(m)(2)(A). The actual deferral percentage and actual contribution percentage of the group of eligible highly compensated employees are determined after any corrective distribution or forfeiture of excess deferrals, excess contributions, or excess aggregate contributions and after any recharacterization of excess contributions required without regard to this section. Only plans and arrangements maintained by the same employer are taken into account under this paragraph (b)(1). If the employer maintains two or more cash or deferred arrangements subject to section 401(k) that are not aggregated pursuant to § 1.401(k)-1(g)(11)(iii) (relating to mandatory disaggregation) multiple use is tested separately with respect to each plan. Thus, for example, if an employer maintains a cash or deferred arrangement with matching contributions, under which elective contributions may be made under either an ESOP or a non-ESOP, multiple use is tested separately with respect to elective contributions and matching

contributions under the ESOP, and with respect to elective contributions and matching contributions under the non-ESOP.

(2) *Alternative limitation.* For purposes of this section, the term "alternative limitation" means the 200 percent or 2 percentage point limits in sections 401(k)(3)(A)(ii)(ii) and 401(m)(2)(A)(ii).

(3) *Aggregate limit*—(i) *In general.* For purposes of this section, the aggregate limit is the greater of:

(A) The sum of—

(1) 1.25 times the greater of the relevant actual deferral percentage or the relevant actual contribution percentage, and

(2) Two percentage points plus the lesser of the relevant actual deferral percentage or the relevant actual contribution percentage. In no event, however, may this amount exceed twice the lesser of the relevant actual deferral percentage or the relevant actual contribution percentage; or

(B) The sum of—

(1) 1.25 times the lesser of the relevant actual deferral percentage or the relevant actual contribution percentage, and

(2) Two percentage points plus the greater of the relevant actual deferral percentage or the relevant actual contribution percentage. In no event, however, may this amount exceed twice the greater of the relevant actual deferral percentage or the relevant actual contribution percentage.

(ii) *Relevant actual deferral percentage and relevant actual contribution percentage defined.* For purposes of paragraph (b)(3)(i) of this section, the term "relevant actual deferral percentage" means the actual deferral percentage of the group of nonhighly compensated employees eligible under the arrangement subject to section 401(k) for the plan year, and the term "relevant actual contribution percentage" means the actual contribution percentage of the group of nonhighly compensated employees eligible under the plan subject to section 401(m) for the plan year beginning with or within the plan year of the arrangement subject to section 401(k).

(iii) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. (i) Assume that Employer G maintains a plan that contains a cash or deferred arrangement under which the actual deferral percentages of highly compensated and nonhighly compensated employees are 5.5 and four percent respectively. The plan also permits employee contributions, and the actual contribution percentages for the two

groups are 4.2 and three percent respectively. The multiple use of the alternative limitation is tested as follows:

(1) Greater of the relevant actual deferral percentage or the relevant actual contribution percentage.....	4.00
(2) 1.25 times (1)	5.00
(3) Lesser of the relevant actual deferral percentage or the relevant actual contribution percentage	3.00
(4) (3) plus two percentage points.....	5.00
(5) (2) + (4)	10.00
(6) 1.25 times (3)	3.75
(7) (1) plus two percentage points.....	6.00
(8) (6) + (7)	9.75
(9) Aggregate limit greater of (5) or (8)	10.00

(ii) In this case, the sum of the actual deferral percentage and the actual contribution percentage of highly compensated employees is 9.70 percent, which is less than the aggregate limit. Therefore, there is no multiple use of the alternative limitation.

Example 2. Employer F maintains a plan subject to section 401(k) with a plan year beginning January 1, and a plan subject to section 401(m) with a plan year beginning July 1. The plan subject to section 401(k) does not correct excess contributions by recharacterization. The first actual deferral percentage taken into account is that for the plan year beginning January 1, 1989. The first actual contribution percentage taken into account is that for the plan year beginning July 1, 1989.

Example 3. (i) Employer E maintains a plan that contains a cash or deferred arrangement and provides for matching contributions. The actual deferral and contribution percentages for a plan year are as follows:

	Actual deferral percentage	Actual contribution percentage
Highly compensated.....	3.6	1.69
Nonhighly compensated.....	1.8	1.35

(ii) The actual deferral percentage of the highly compensated employees exceeds the normal limit (1.25 times 1.8, or 2.25%) but not the alternative limit (two plus 1.8, but not more than twice 1.8, or 3.6%). The actual contribution percentage of the highly compensated employees does not exceed the normal limit (1.25 times 1.35, or 1.69%). Accordingly, the plan satisfies both the actual deferral and contribution percentage tests. Since the actual contribution percentage of the highly compensated employees does not exceed the normal limit, condition (iv) of paragraph (b)(1) of this section is not satisfied. Therefore, there is no multiple use of the alternative limitation.

(c) **Correction of multiple use—(1) In general.** If multiple use of the alternative limitation occurs with respect to two or more plans or arrangements maintained by an employer, it must be corrected by reducing the actual deferral percentage

or actual contribution percentage of highly compensated employees in the manner described in paragraph (c)(3) of this section. Instead of making this reduction, the employer may eliminate the multiple use of the alternative limitation by making qualified nonelective contributions in accordance with § 1.401(m)-1(b)(5)(F)(1) or § 1.401(k)-1(b)(5) and (e)(1).

(2) **Treatment of required reduction.** The required reduction is treated as an excess contribution under the arrangement subject to section 401(k) or excess aggregate contribution under the plan subject to section 401(m). However, if an excess contribution arising under this section is recharacterized as an employee contribution, the recharacterized amount is treated as an excess aggregate contribution.

(3) **Required reduction.** The amount of the reduction of the actual deferral percentage of the entire group of highly compensated employees eligible in the arrangement subject to section 401(k) is calculated in the manner described in § 1.401(k)-1(f)(2) or the amount of the reduction of the actual contribution percentage of the entire group of highly compensated employees eligible in the plan subject to section 401(m) is calculated in the manner described in § 1.401(m)-1(e)(2), as designated in the plan, so that there is no multiple use of the alternative limitation. The employer may elect to reduce the actual deferral ratios or the actual contribution ratios, as designated in the plan, either for all highly compensated employees under the plan or arrangements subject to reduction or for only those highly compensated employees who are eligible in both the arrangement subject to section 401(k) and the plan subject to section 401(m).

(4) **Examples.** The principles of this paragraph (c) are illustrated by the following examples. In all cases, the employer maintains both an arrangement subject to section 401(k) and a plan subject to section 401(m). Assume that there is no income or loss allocable to the elective, employee, or matching contributions.

Example 1. (i) All employees of Employer Q are eligible in both an arrangement subject to section 401(k) and a plan subject to section 401(m). Both plans have a calendar plan year. The plans provide that multiple use of the alternative limitation will be corrected in the plan subject to section 401(m) and that any required reduction in actual contribution ratios will apply only to employees eligible to participate in both arrangements. Employees X and Y are highly compensated. Each received compensation of \$100,000, deferred \$6,000, received a \$3,000 matching contribution, and made employee contributions of \$3,000. Actual deferral and

contribution percentages under the arrangement and plan for the 1989 plan year are shown below. No excess deferrals, excess contributions, or excess aggregate contributions have yet been required to be distributed, forfeited, or recharacterized under the plan.

	Actual deferral percentage	Actual contribution percentage
Highly compensated.....	6	6
Nonhighly compensated.....	4	4

(ii) The aggregate limit and amount required, to be corrected are determined as follows:

Step 1: Determination of Aggregate Limit	
(1) Greater of relevant actual deferral percentage or relevant actual contribution percentage.....	4.0
(2) 1.25 times (1)	5.0
(3) Lesser of relevant actual deferral percentage or relevant actual contribution percentage	4.0
(4) (3) plus two percentage points.....	6.0
(5) (2) + (4)	11.0
(6) 1.25 times (3)	5.0
(7) (1) plus two percentage points.....	6.0
(8) (6) + (7)	11.0
(9) Aggregate limit Greater of (5) or (8)	11.0
Step 2: Calculation of Correction Amount	
(10) Actual deferral percentage of highly compensated.....	6.0
(11) Maximum permitted actual contribution percentage of highly compensated ((9)-(10))	5.0
(12) Amount taken into account in determining actual contribution percentage of highly compensated Employee X	\$6,000
(13) Maximum amount permitted without use of alternative limitation ((11) × compensation of Employee X)	\$5,000
(14) Excess aggregate contribution ((12)-(13))	\$1,000

(iii) A similar correction must be made for Employee Y.

Example 2. Same as **Example 1**, but the plan corrects the multiple use in the arrangement subject to section 401(k) and provides that excess contributions are recharacterized. In this case, the aggregate limit for the plans will be 11 percent. Similarly, the excess contributions for Employees X and Y, determined in a manner analogous to that used in **Example 1**, will be \$1,000. When this is recharacterized, the actual contribution percentage for these employees will increase to seven percent, resulting in an excess aggregate contribution of \$1,000 that must be distributed.

Example 3. Same as **Example 1**, except that Employee Y is not eligible to participate in the arrangement subject to section 401(k). No reduction of Y's actual contribution ratio is required because Y is only in the plan subject to section 401(m). In order to reduce the actual contribution percentage of the entire group of highly compensated employees

eligible for the plan subject to section 401(m) to five percent, the plan must reduce X's actual contribution percentage to four percent. X's employee and matching contributions are limited to \$4,000. Therefore X has an excess aggregate contribution of \$2,000.

(d) *Effective date*—(1) *General rule.* This section is effective for plan years beginning after December 31, 1988, or such later date provided in § 1.402(m)-1(g).

(2) *Transition rule.* For plan years beginning before January 1, 1992, a reasonable interpretation of the rules set forth in sections 401(k) and (m) of the Internal Revenue Code (as in effect during those years) may be relied upon to determine whether a plan was qualified during those years. For plan years beginning before January 1, 1992, a plan may be restructured only in accordance with § 1.401(k)-1(h)(3)(iii) or § 1.401(m)-1(g)(5)(ii).

Par. 5. Section 1.402(a)-1 is amended by revising paragraph (d) to read as follows:

§ 1.402(a)-1 *Taxability of beneficiary under a trust which meets the requirements of section 401(a).*

(d) *Salary reduction, cash or deferred arrangements*—(1) *Inclusion in income.* Whether a contribution to an exempt trust or plan described in section 401(a) or 403(a) is made by the employer or the employee is determined on the basis of the particular facts and circumstances of each case. Nevertheless, an amount contributed to a plan or trust will, except as otherwise provided under paragraph (d)(2) of this section, be treated as contributed by the employee if it was contributed at the employee's election, even though the election was made before the year in which the amount was earned by the employee or before the year in which the amount became currently available to the employee. Any amount treated as contributed by the employee is includible in the gross income of the employee for the year in which the amount would have been received by the employee but for the election. Thus, for example, amounts contributed to an exempt trust or plan by reason of a salary reduction agreement under a cash or deferred arrangement are treated as received by the employee when they would have been received by the employee but for the election to defer. Accordingly, they are includible in the gross income of the employee for that year (except as provided under paragraph (d)(2) of this section). See § 1.401(k)-1(a)(3)(iii) and (2)(i) for the

meaning of currently available and cash or deferred arrangement, respectively.

(2) *Amounts not included in income*—(i) *Qualified cash or deferred arrangement.* Elective contributions as defined in § 1.401(k)-1(g)(3) for a plan year made by an employer on behalf of an employee pursuant to a cash or deferred election under a qualified cash or deferred arrangement, as defined in § 1.401(k)-1(a)(4)(i), are not treated as received by or distributed to the employee or as employee contributions. For plan years beginning after December 31, 1992, whether a cash or deferred election is made under a qualified cash or deferred arrangement is determined without regard to the special rules for certain collectively bargained plans contained in § 1.401(k)-1(a)(7). As a result, elective contributions under these plans are treated as employee contributions for purposes of this section if the cash or deferred arrangement does not satisfy the actual deferral percentage test of section 401(k)(3) or otherwise fails to be a qualified cash or deferred arrangement.

(ii) *Matching contributions.* Matching contributions described in § 1.401(m)-1(f)(12) and section 401(m)(4) are not treated as contributed by an employee merely because they are made by the employer as a result of an employee's election.

(iii) *Effect of certain one-time elections.* Amounts contributed to an exempt plan or trust described in section 401(a) or 403(a) pursuant to the one-time irrevocable employee election to participate in a plan described in § 1.401(k)-1(a)(3)(iv) are not treated as contributed by an employee. Similarly, amounts contributed to an exempt plan or trust described in section 401(a) or 403(a) in which self-employed individuals may participate pursuant to the one-time irrevocable election described in § 1.401(k)-1(a)(6)(ii)(C) are not treated as contributed by an employee.

(3) *Effective date and transition rules*—(i) *Effective date.* In the case of a plan or trust that does not include a salary reduction or cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to taxable years ending after that date.

(ii) *Transition rule for cash or deferred arrangements in existence on June 27, 1974*—(A) *General rule.* In the case of a plan or trust that includes a salary reduction or a cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, as defined in § 1.401(k)-1(g)(12), plan years beginning after July

18, 1984). For plan years beginning prior to January 1, 1980 (or, in the case of a pre-ERISA money purchase plan, plan years beginning before July 19, 1984), the taxable year of inclusion in gross income of the employee of any amount so contributed by the employer to the trust is determined in a manner consistent with Rev. Rul. 56-497, 1956-2 CB 284, Rev. Rul. 63-180, 1963-2 CB 189, and Rev. Rul. 68-89, 1968-1 CB 402.

(B) *Meaning of cash or deferred arrangement in existence on June 27, 1974.* A cash or deferred arrangement is considered as in existence on June 27, 1974, if, on or before that date, it was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholders), even though no amounts had been contributed pursuant to the terms of the arrangement as of that date.

(iii) *Reasonable interpretation for plan years beginning after 1979 and before 1992.* For plan years beginning after December 31, 1979 (or in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1992, a reasonable interpretation of the rules set forth in section 401(k) (as in effect during those years) may be relied upon to determine whether contributions were made under a qualified cash or deferred arrangement.

(iv) *Special rule for governmental and collectively bargained plans.* For plan years beginning before January 1, 1993, a nonqualified cash or deferred arrangement will be treated as a qualified cash or deferred arrangement solely for purposes of paragraph (d)(2)(i) of this section if it is part of either a plan adopted by a state or local government before May 6, 1986, or a plan (or portion of a plan) that automatically satisfies section 401(a)(4) under § 1.401(k)-1(a)(7), relating to certain collectively bargained plans.

Par. 6. New §§ 1.402(g)-0 and 1.402(g)-1 are added to read as follows:

§ 1.402(g)-0 *Limitation on exclusion for elective deferrals, table of contents.*

This section contains the captions that appear in § 1.402(g)-1.

§ 1.402(g)-1 *Limitation on exclusion for elective deferrals.*

- (a) In general.
- (b) Elective deferrals.
- (c) Certain one-time irrevocable elections.
- (d) Applicable limit.
 - (1) In general.
 - (2) Special adjustment for elective deferrals with respect to a section 403(b) annuity contract.

- (3) Special adjustment for elective deferrals with respect to a section 403(b) annuity contract for certain long-term employees.
- (4) Example.
- (e) Treatment of excess deferrals.
 - (1) Plan qualification.
 - (i) Effect of excess deferrals.
 - (ii) Treatment of excess deferrals as employer contributions.
 - (iii) Definition of excess deferrals.
 - (2) Correction of excess deferrals after the taxable year.
 - (3) Correction of excess deferrals during taxable year.
 - (4) Plan provisions.
 - (5) Income allocable to excess deferrals.
 - (i) General rule.
 - (ii) Method of allocating income.
 - (iii) Alternative method of allocating income.
 - (iv) Safe harbor method of allocating gap period income.
 - (6) Coordination with distribution or recharacterization of excess contributions.
 - (7) No employee or spousal consent required.
 - (8) Tax treatment.
 - (i) Corrective distributions on or before April 15 after close of taxable year.
 - (ii) Special rule for 1987 and 1988 excess deferrals.
 - (iii) Distributions of excess deferrals after correction period.
 - (9) No reduction of required minimum distribution.
 - (10) Partial correction.
 - (11) Examples.
- (f) Community property laws.
- (g) Effective date.
 - (1) In general.
 - (2) Deferrals under collective bargaining agreements.
 - (3) Transition rule.
 - (4) Partnership cash or deferred arrangements.

§ 1.402(g)-1 Limitation on exclusion for elective deferrals.

(a) *In general.* The excess of an individual's elective deferrals for any taxable year over the applicable limit for the year may not be excluded from gross income under sections 402(a)(8), 402(h)(1)(B), 403(b), 408(k)(6), or 501(c)(18). Thus, an individual's elective deferrals in excess of the applicable limit for a taxable year (i.e., the individual's excess deferrals for the year) must be included in gross income for the year.

(b) *Elective deferrals.* An individual's elective deferrals for a taxable year are the sum of the following:

(1) Any elective contribution under a qualified cash or deferred arrangement (as defined in section 401(k)) to the extent not includible in the individual's gross income for the taxable year on account of section 402(a)(8) (before applying the limits of section 402(g) or this section).

(2) Any employer contribution to a simplified employee pension (as defined

in section 408(k)) to the extent not includible in the individual's gross income for the taxable year on account of section 402(h)(1)(B) (before applying the limits of section 402(g) or this section).

(3) Any employer contribution to an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)) to the extent not includible in the individual's gross income for the taxable year on account of section 403(b) (before applying the limits of section 402(g) or this section).

(4) Any employee contribution designated as deductible under a trust described in section 501(c)(18) to the extent deductible from the individual's income for the taxable year on account of section 501(c)(18) (before applying the limits of section 402(g) or this section). For purposes of this section, the employee contribution is treated as though it were excluded from the individual's gross income.

(c) *Certain one-time irrevocable elections.* An employer contribution is not treated as an elective deferral under paragraph (b) of this section if the contribution is made pursuant to a one-time irrevocable election made by the employee:

(1) In the case of an annuity contract under section 403(b), at the time of initial eligibility to participate in the salary reduction agreement;

(2) In the case of a qualified cash or deferred arrangement, at a time when, under § 1.401(k)-1(a)(3)(iv), the election is not treated as a cash or deferred election;

(3) In the case of a trust described in section 501(c)(18), at the time of initial eligibility to have the employer contribute on the employee's behalf to the trust.

(d) *Applicable limit*—(1) *In general.* Except as adjusted under paragraphs (d)(2) and (d)(3) of this section, the applicable limit for an individual's taxable year beginning in the 1987 calendar year is \$7,000. This amount is increased for the taxable year beginning in 1988 and subsequent calendar years in the same manner as the \$90,000 amount is adjusted under section 415(d).

(2) *Special adjustment for elective deferrals with respect to a section 403(b) annuity contract.* The applicable limit for an individual who makes elective deferrals described in paragraph (b)(3) of this section for a taxable year is adjusted by increasing the applicable limit otherwise determined under paragraph (d)(1) of this section by the amount of the individual's elective deferrals described in paragraph (b)(3) of this section for the

taxable year. This adjustment cannot cause the applicable limit for any taxable year to exceed \$9,500.

(3) *Special adjustment for elective deferrals with respect to a section 403(b) annuity contract for certain long-term employees.* The applicable limit for an individual who is a qualified employee (as defined in section 402(g)(8)(C)) and has elective deferrals described in paragraph (b)(3) of this section for a taxable year is adjusted by increasing the applicable limit otherwise determined under paragraphs (d)(1) and (d)(2) of this section in accordance with section 402(g)(8)(A).

(4) *Example.* The provisions of this paragraph (d) are illustrated by the following example.

Example. Employer X maintains a cash or deferred arrangement under section 401(k), and offers its employees section 403(b) contracts to which elective deferrals may be made. For the 1987 taxable year, three of X's employees, A, B, and C, contribute \$3,500, \$1,000, and \$8,500, respectively, as elective deferrals under the section 403(b) contract. The maximum amounts that A, B, and C may contribute to the cash or deferred arrangement are \$6,000, \$7,000, and \$1,000, respectively. B may only contribute \$7,000 under the cash or deferred arrangement because the special adjustment under paragraph (d)(2) of this section applies only to section 403(b) annuity contracts. B could, of course, contribute up to \$2,500 under the section 403(b) contract (to the extent otherwise permitted), in addition to the \$7,000 under the cash or deferred arrangement.

(e) *Treatment of excess deferrals*—(i) *Plan qualification*—(i) *Effect of excess deferrals.* For plan years beginning before January 1, 1988, a plan, annuity contract, simplified employee pension, or trust does not fail to meet the requirements of section 401(a), section 403(b), section 408(k), or section 501(c)(18), respectively, merely because excess deferrals are made with respect to the plan, contract, pension, or trust. For plan years beginning after December 31, 1987, see section 401(a)(30) and § 1.401(a)-30 for the effect of excess deferrals on the qualification of a plan or trust under section 401(a). For purposes of determining whether a plan or trust complies in operation with section 401(a)(30), excess deferrals that are distributed under paragraph (e)(2) or (3) of this section are disregarded. Similar rules apply to annuity contracts under section 403(b), simplified employee pensions under section 408(k), and plans or trusts under section 501(c)(28).

(ii) *Treatment of excess deferrals as employer contributions.* For other purposes of the Code, including sections 401(a)(4), 401(k)(3), 404, 409, 411, 412,

and 416, excess deferrals must be treated as employer contributions even if they are distributed in accordance with paragraph (e)(2) or (3) of this section. However, excess deferrals of a nonhighly compensated employee are not taken into account under section 401(k)(3) [the actual deferral percentage test] to the extent the excess deferrals are prohibited under section 401(a)(30). Excess deferrals are also treated as employer contributions for purposes of section 415 unless distributed under paragraph (e)(2) or (3) of this section.

(iii) *Definition of excess deferrals.* The term "excess deferrals" means the excess of an individual's elective deferrals for any taxable year, as defined in § 1.402(g)-1(b), over the applicable limit under section 402(g)(1) for the taxable year.

(2) *Correction of excess deferrals after the taxable year.* A plan may provide that if any amount is included in the gross income of an individual under paragraph (a) of this section for a taxable year:

(i) Not later than the first April 15 (or such earlier date specified in the plan) following the close of the individual's taxable year, the individual may notify each plan under which deferrals were made of the amount of the excess deferrals received by that plan. A plan may provide that an individual is deemed to have notified the plan of excess deferrals to the extent the individual has excess deferrals for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer. A plan may instead provide that the employer may notify the plan on behalf of the individual under these circumstances.

(ii) Not later than the first April 15 following the close of the taxable year, the plan may distribute to the individual the amount designated under paragraph (e)(2)(i) of this section (and any income allocable to that amount).

(3) *Correction of excess deferrals during taxable year—(i)* A plan may provide that an individual who has excess deferrals for a taxable year may receive a corrective distribution of excess deferrals during the same year. This corrective distribution may be made only if all of the following conditions are satisfied:

(A) The individual designates the distribution as an excess deferral. A plan may provide that an individual is deemed to have designated the distribution to the extent the individual has excess deferrals for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer. A

plan may instead provide that the employer may make the designation on behalf of the individual under these circumstances.

(B) The correcting distribution is made after the date on which the plan received the excess deferral.

(C) The plan designates the distribution as a distribution of excess deferrals.

(ii) The provisions of this paragraph (e)(3) are illustrated by the following example:

Example. S is a 62 year old individual who participates in Employer Y's qualified cash or deferred arrangement. In January 1991, S withdraws \$5,000 from Y's cash or deferred arrangement. From February through September, S defers \$900 per month. On October 1, S leaves Employer Y and becomes employed by Employer Z (unrelated to Y). During the remainder of 1991, S defers \$1,800 under Z's qualified cash or deferred arrangement. In January 1992, S realizes that S has deferred a total of \$9,000 in 1991, and therefore has a \$525 excess deferral (\$9,000 minus \$8,475, the applicable limit for 1991). An additional \$525 must be distributed to S before April 15, 1992, to correct the excess deferral. The \$5,000 withdrawal did not correct the excess deferral because it occurred before the excess deferral was made.

(4) *Plan provisions.* In order to distribute excess deferrals pursuant to paragraphs (e)(2) or (e)(3) of this section, a plan must contain language permitting distribution of excess deferrals. A plan may require the notification in paragraphs (e)(2) and (e)(3) of this section to be in writing and may require that the employee certify or otherwise establish that the designated amount is an excess deferral. A plan need not permit distribution of excess deferrals.

(5) *Income allocable to excess deferrals—(i) General rule.* The income allocable to excess deferrals is equal to the sum of the allocable gain or loss for the taxable year of the individual and, if the plan so provides, the allocable gain or loss for the period between the end of the taxable year and the date of distribution (the "gap period").

(ii) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess deferrals, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under a plan for the plan year, and is used by the plan for allocating income to participants' accounts.

(iii) *Alternative method of allocating income.* A plan may allocate income to excess deferrals by multiplying the income for the taxable year (and the gap period, if the plan so provides) allocable

to elective contributions by a fraction. The numerator of the fraction is the excess deferrals by the employee for the taxable year. The denominator of the fraction is equal to the sum of:

(A) The total account balance of the employee attributable to elective contributions as of the beginning of the taxable year, plus

(B) The employee's elective contributions for the taxable year (and the gap period, if the plan so provides).

(iv) *Safe harbor method of allocating gap period income.* Under the safe harbor method, income on excess deferrals for the gap period is equal to 10 percent of the income allocable to excess deferrals for the taxable year (calculated under the method described in paragraph (e)(5)(iii) of this section), multiplied by the number of calendar months that have elapsed since the end of the taxable year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of the month is treated as made on the last day of the preceding month. A distribution made after the fifteenth day of the month is treated as made on the first day of the next month.

(6) *Coordination with distribution or recharacterization of excess contributions.* The amount of excess deferrals that may be distributed under this paragraph (e) with respect to an employee for a taxable year is reduced by any excess contributions previously distributed or recharacterized with respect to the employee for the plan year beginning with or within the taxable year. In the event of a reduction under this paragraph (e)(6), the amount of excess contributions includible in the gross income of the employee and reported by the employer as a distribution of excess contributions is reduced by the amount of the reduction under this paragraph (e)(6). See § 1.401(k)-1(f)(5)(i). In no case may an individual receive from a plan as a corrective distribution for a taxable year under paragraph (e)(2) or (e)(3) of this section an amount in excess of the individual's total elective deferrals under the plan for the taxable year.

(7) *No employee or spousal consent required.* A corrective distribution of excess deferrals (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) or 417.

(8) *Tax treatment—(i) Corrective distributions on or before April 15 after close of taxable year.* A corrective distribution of excess deferrals within

the period described in paragraph (e)(2) or (e)(3) of this section is excludable from the employee's gross income. However, the income allocable to excess deferrals is includible in the employee's gross income for the taxable year in which the allocable income is distributed. The corrective distribution of excess deferrals (and income) is not subject to the early distribution tax of section 72(t) and is not treated as a distribution for purposes of applying the excise tax under section 4980A.

(ii) *Special rule for 1987 and 1988 excess deferrals.* Income on excess deferrals for 1987 or 1988 that were timely distributed on or before April 17, 1989, may be reported by the recipient either in the year described in paragraph (e)(8)(i) of this section, or in the year in which the employee would have received the elective deferrals had the employee originally elected to receive the amounts in cash.

(iii) *Distributions of excess deferrals after correction period.* If excess deferrals (and income) for a taxable year are not distributed within the period described in paragraphs (e)(2) and (e)(3) of this section, they may only be distributed when permitted under section 401(k)(2)(B). These amounts are includible in gross income when distributed, and are treated for purposes

of the distribution rules otherwise applicable to the plan as elective deferrals (and income) that were excludable from the individual's gross income under section 402(g). Thus, any amount includible in gross income for any taxable year under this section that is not distributed by April 15 of the following taxable year is not treated as an investment in the contract for purposes of section 72 and is includible in the employee's gross income when distributed from the plan. Excess deferrals that are distributed under this paragraph (e)(8)(iii) are treated as employer contributions for purposes of section 415 when they are contributed to the plan.

(9) *No reduction of required minimum distribution.* A distribution of excess deferrals (and income) under paragraphs (e)(2) and (e)(3) of this section is not treated as a distribution for purposes of determining whether the plan meets the minimum distribution requirements of section 401(a)(9).

(10) *Partial correction.* Any distribution under paragraphs (e)(2) or (e)(3) of this section of less than the entire amount of excess deferrals (and income) is treated as a pro rata distribution of excess deferrals and income.

(11) *Examples.* The provisions of this paragraph are illustrated by the following examples. Assume in *Examples 1* and *2* that there is no income or loss allocable to the elective deferrals.

Example 1. Employee A is a 60-year old highly compensated employee who participates in Employer M's cash or deferred arrangement. During the period of January through September of 1988, A contributed \$7,000 to the arrangement in elective deferrals. During the same period A also contributed \$813 in elective deferrals under a plan of an unrelated employer. In December of 1988, A made a withdrawal of \$1,000 from Employer M's plan but did not designate this as a withdrawal of an excess deferral. In January of 1989, A notifies Employer M of an excess deferral, specifying a distribution of \$500 for 1988. To correct the excess deferrals, A must receive this additional \$500 even though A has already withdrawn \$1,000 for 1988. A may exclude from income in 1988 only \$7,313. However, if the \$500 is distributed by April 25, 1989, the distribution is excludable from A's gross income in 1989. Even if A withdraws the \$500, M must take into account the entire \$7,000 in computing A's actual deferral percentage for 1988.

Example 2. (i) Corporation X maintains a cash or deferred arrangement. The plan year is the calendar year. For plan year 1989, all 10 of X's employees are eligible to participate in the plan. The employees' compensation, contributions, and actual deferral ratios are shown in the following table:

Employee	Compensation	Contribution	Actual deferral ratio (percent)
A.....	\$140,000	\$7,000	5.0
B.....	70,000	7,000	10.0
C.....	70,000	7,000	10.0
D.....	45,000	2,250	5.0
E.....	40,000	4,000	10.0
F.....	35,000	1,750	5.0
G.....	35,000	350	1.0
H.....	30,000	3,000	10.0
I.....	17,500	0	0
J.....	17,500	0	0.0

(ii) Employees A, B, and C are highly compensated employees within the meaning of section 414(q). Employees D, E, F, G, H, I, and J are nonhighly compensated employees. The actual deferral percentages for the highly compensated employees and nonhighly compensated employees are 8.33 percent and 4.43 percent, respectively. These percentages do not satisfy the requirements of section 401(k)(3)(A)(ii). The actual deferral percentage for the highly compensated employees may not exceed 8.43 percent.

(iii) The plan reduces the actual deferral ratios of B and C to 7.14 percent by distributing \$2,002 (\$7,000 - .0714 × \$70,000) to each in January 1990. Section 401(k)(3)(A)(ii) is therefore satisfied.

(iv) In February 1990, B notifies X that B made elective deferrals of \$2,000 under a qualified cash or deferred arrangement

maintained by an unrelated employer in 1989, and requests distribution of \$2,000 from X's plan. However, since B has already received a distribution of \$2,002 to meet the ADP test, no additional amounts may be distributed as excess deferrals by this plan. But X must report \$2,000 as a distribution of an excess deferral and \$2 as a distribution of an excess contribution.

(v) Excess deferrals distributed to B are taken into account in calculating B's actual deferral ratio. See paragraph (e)(1)(ii) of this section. Therefore B's actual deferral ratio must be recalculated as 10.00 percent (\$8,998 divided by \$70,000). The actual deferral percentages do not satisfy section 401(k)(3)(A)(ii). Further correction must be made.

Example 3. Employee T has excess deferrals of \$1,000. The income attributable to

excess deferrals is \$100. T properly notifies the employer, and requests a distribution of the excess deferral (and income) on February 1. The plan distributes \$1,000 to T by April 15. Because the plan did not distribute any additional amount as income, \$909 is treated as a distribution of excess deferrals, and \$91 is treated as a distribution of earnings. With respect to amounts remaining in the account, \$91 is treated as an elective deferral and is not included in T's investment in the contract. Because it was not distributed by the required date, the \$91 is includible in gross income upon distribution as well as in the year of deferral.

(f) *Community property laws.* This section is applied without regard to community property laws.

(g) *Effective date*—(1) *In general.* Except as otherwise provided, the provisions of this section are effective for taxable years beginning after December 31, 1986.

(2) *Deferrals under collective bargaining agreements.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, the provisions of this section do not apply to contributions made pursuant to the collective bargaining agreement for taxable years beginning before the earlier of January 1, 1989, or the date on which the agreement terminates (determined without regard to any extension thereof after February 28, 1986). These contributions under a collective bargaining agreement are taken into account for purposes of applying this section to elective deferrals under plans not described in this paragraph (g)(2).

(3) *Transition rule.* For taxable years beginning before January 1, 1992, a plan or an individual may rely on a reasonable interpretation of the rules set forth in section 402(g), as in effect during those years.

(4) *Partnership cash or deferred arrangements.* For purposes of section 402(g), employer contributions for any plan year beginning after December 31, 1986, and before January 1, 1989, under an arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf will be treated as elective contributions only if the arrangement was intended to satisfy and did satisfy the nondiscrimination test of section 401(k)(3) and § 1.401(k)-1(b) for the plan year.

Par. 7. Section 1.411(a)-4 is amended by adding a new paragraph (b)(7) to read as follows:

§ 1.411(a)-4 Forfeitures, suspensions, etc.

(b) * * *

(7) *Certain matching contributions.* A matching contribution (within the meaning of section 401(m)(4)(A) and § 1.401(m)-1(f)(12)) is not treated as forfeitable even if under the plan it may be forfeited under § 1.401(m)-1(e)(1) because the contribution to which it relates is treated as an excess contribution (within the meaning of § 1.402(k)-1(f)(2) and (g)(7)), excess deferral (within the meaning of § 1.402(g)-1(e)(1)(iii)), or excess aggregate contribution (within the meaning of § 1.401(m)-1(f)(8)).

Par. 8. In § 1.411(d)-4, A-2 is amended by adding new paragraphs (b)(2)(x) and (b)(2)(xi) to read as follows:

§ 1.411(d)-4 Section 411(d)(6) protected benefits.

* * *

A-2: * * *

(b) * * *

(2) * * *

(x) *Amendment of hardship distribution standards.* A qualified cash or deferred arrangement that permits hardship distributions under § 1.401(k)-1(d)(2) may be amended to specify or modify nondiscriminatory and objective standards for determining the existence of an immediate and heavy financial need, the amount necessary to meet the need, or other conditions relating to eligibility to receive a hardship distribution. For example, a plan will not be treated as violating section 411(d)(6) merely because it is amended to specify or modify the resources an employee must exhaust to qualify for a hardship distribution or to require employees to provide additional statements or representations to establish the existence of a hardship. A qualified cash or deferred arrangement may also be amended to eliminate hardship distributions.

(xi) *Section 415 benefit limitations.* Accrued benefits under a plan as of the first day of the first limitation year beginning after December 31, 1986, that exceed the benefit limitations under section 415(b) effective on the first day of the plan's first limitation year beginning after December 31, 1986, because of a change in the terms and conditions of the plan made after May 5, 1986, or the establishment of a plan after that date, may be reduced to the level permitted under section 415(b).

* * *

Par. 9. Section 1.415-6 is amended by revising paragraph (b)(1), the introductory text of paragraph (b)(6), and the first sentence of paragraph (b)(6)(iv) to read as follows:

§ 1.415-6 Limitation for defined contribution plans.

* * *

(b) *Annual additions*—(1) *In general*—

(i) *Limitation years beginning after December 31, 1986.* For limitation years beginning after December 31, 1986, or such later date provided in paragraph (b)(1)(iii) of this section, the term "annual addition" means, for purposes of this section, the sum, credited to a participant's account for any limitation year, of:

- (A) Employer contributions;
- (B) Employee contributions; and
- (C) Forfeitures.

Contributions do not fail to be annual additions merely because they are excess deferrals, excess contributions, or excess aggregate contributions or merely because excess contributions or excess aggregate contributions are corrected through distribution or recharacterization. Excess deferrals that are distributed in accordance with § 1.402(g)-1(e)(2) or (3) are not annual additions.

(ii) *Limitation years beginning before January 1, 1987.* For limitation years beginning before January 1, 1987, or such later date provided in paragraph (b)(1)(iii) of this section, the term "annual addition" means, for purposes of this section, the sum, credited to a participant's account for any limitation year, of:

(A) Employer contributions;

(B) The lesser of the amount of employee contributions in excess of 6 percent of compensation (as defined in paragraph (a)(3) of this section) for the limitation year, or one-half of the employee contributions for that year; and

(C) Forfeitures.

(iii) *Certain collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, the date specified in this paragraph is the earlier of:

(A) The date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after February 28, 1986); or

(B) December 31, 1988, in the case of paragraph (b)(1)(i) of this section, and January 1, 1989, in the case of paragraph (b)(1)(ii) of this section.

(6) *Excess annual additions.* If, as a result of the allocation of forfeitures, a reasonable error in estimating a participant's annual compensation, a reasonable error in determining the amount of elective deferrals (within the meaning of section 402(g)(3)) that may be made with respect to any individual under the limits of section 415; or under other limited facts and circumstances that the Commissioner finds justify the availability of the rules set forth in this paragraph (b)(6), the annual additions under the terms of a plan for a particular participant would cause the limitations of section 415 applicable to that participant for the limitation year to be exceeded, the excess amounts shall not be deemed annual additions in that limitation year if they are treated in

accordance with any one of the following:

(iv) Notwithstanding paragraphs (b)(6) (i), (ii), or (iii) of this section, the plan may provide for the distribution of elective deferrals (within the meaning of section 402(g)(3)) or the return of employee contributions (whether voluntary or mandatory), to the extent that the distribution or return would reduce the excess amounts in the participant's account. These amounts are disregarded for purposes of section 402(g), the actual deferral percentage test of section 401(k)(3), and the actual contribution percentage test of section 401(m)(2). * * *

Par. 10. Section 1.416-1 is amended by adding new questions and answers M-18, M-19, and M-20 to read as follows:

§ 1.416-1 Questions and answers on top-heavy plans.

M-18 Q. May qualified nonelective contributions described in section 401(m)(4)(C) be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416?

A. Yes. This is the case even if the qualified nonelective contributions are taken into account under the actual deferral percentage test of § 1.401(k)-1(b)(2) or under the actual contribution percentage test of § 1.401(m)-1(b).

M-19 Q. May matching contributions described in section 401(m)(4)(A) be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416?

A. Matching contributions allocated to key employees are treated as employer contributions for purposes of determining the minimum contribution or benefit under section 416. However, if a plan uses contributions allocated to employees other than key employees on the basis of employee contributions or elective contributions to satisfy the minimum contribution requirement, these contributions are not treated as matching contributions for purposes of applying the requirements of sections 401(k) and 401(m) for plan years beginning after December 31, 1988. Thus these contributions must meet the nondiscrimination requirements of section 401(a)(4) without regard to section 401(m). See § 1.401(m)-1(f)(12)(iii).

M-20 Q. May elective contributions be treated as employer contributions for purposes of satisfying the minimum contribution or benefit requirement of section 416(c)(2)?

A. Elective contributions on behalf of key employees are taken into account in determining the minimum required contribution under section 416(c)(2). However, elective contributions on behalf of employees other than key employees may not be treated as employer contributions for purposes of the minimum contribution or benefit requirement of section 416. See section 401(k)(4)(C) and the regulations thereunder. This Question and Answer is effective for plan years beginning after December 31, 1988.

PART 54—PENSION EXCISE TAXES

Par. 11. The authority citation for part 54 continues to read in part:

Authority: 26 U.S.C 7805 * * *.

Par. 12. New §§ 54.4979-0 and 54.4979-1 are added to read as follows:

§ 54.4979-0 Excise tax on certain excess contributions and excess aggregate contributions; table of contents.

This section contains the captions that appear in § 54.9479-1.

§ 54.4979-1 Excise tax on certain excess contributions and excess aggregate contributions.

(a) In general.

- (1) General rule.
- (2) Liability for tax.
- (3) Due date and form for payment of tax.
- (4) Special rule for simplified employee pensions.

(b) Definitions.

- (1) Excess aggregate contributions.
- (2) Excess contributions.
- (3) Plan.

(c) No tax when excess distributed within 2½ months of close of year or additional employer contributions made.

- (1) General rule.
 - (2) Tax treatment of distributions.
 - (3) Income.
 - (4) Example.
- (d) Effective date.
- (1) General rule.
 - (2) Section 403(b) annuity contracts.
 - (3) Collectively bargained plans and plans of state or local governments.
 - (4) Collectively bargained plans of state or local governments.
 - (5) Plan years beginning before January 1, 1992.

§ 54.4979-1 Excise tax on certain excess contributions and excess aggregate contributions.

(a) *In general*—(1) *General rule.* In the case of any plan (as defined in paragraph (b)(3) of this section), there is imposed a tax for the employer's taxable year equal to 10 percent of the sum of:

(i) Any excess contributions under a plan for the plan year ending in the taxable year; and

(ii) Any excess aggregate contributions under the plan for the plan year ending in the taxable year.

(2) *Liability for tax.* The tax imposed by paragraph (a)(1) of this section is to be paid by the employer. In the case of a collectively bargained plan to which section 413(b) applies, all employers who are parties to the collective bargaining agreement and whose employees are participants in the plan are jointly and severally liable for the tax.

(3) *Due date and form for payment of tax*—(i) The tax described in paragraph (a)(1) of this section is due on the last day of the 15th month after the close of the plan year to which the excess contributions or excess aggregate contributions relate.

(ii) An employer that owes the tax described in paragraph (a)(1) of this section must file the form prescribed by the Commissioner for the payment of the tax.

(4) *Special rule for simplified employee pensions*—(i) An employer that maintains a simplified employee pension (SEP) as defined in section 408(k) that accepts elective contributions is exempted from the tax of section 4979 and paragraph (a)(1) of this section if it notifies its employees of the fact and tax consequences of excess contributions within 2½ months following the plan year for which excess contributions are made. The notification must meet the standards of paragraph (a)(4)(ii) of this section.

(ii) The employer's notification to each affected employee of the excess SEP contributions must specifically state, in a manner calculated to be understood by the average plan participant: the amount of the excess contributions attributable to that employee's elective deferrals; the calendar year for which the excess contributions were made; that the excess contributions are includible in the affected employee's gross income for the specified calendar year; and that failure to withdraw the excess contributions and income attributable thereto by the due date (plus extensions) for filing the affected employee's tax return for the preceding calendar year may result in significant penalties.

(iii) If an employer does not notify its employees by the last day of the 12-month period following the year of excess SEP contributions, the SEP will no longer be considered to meet the requirements of section 408(k)(6).

(b) *Definitions.* The following is a list of terms and definitions to be used for purposes of section 4979 and this section:

(1) *Excess aggregate contributions.* The term "excess aggregate contribution" has the meaning set forth in § 1.401(m)-1(f)(8) of this chapter. For purposes of determining excess aggregate contributions under an annuity contract described in section 403(b), the contract is treated as a plan described in section 401(a).

(2) *Excess contributions.* The term "excess contributions" has the meaning set forth in sections 401(k)(8)(B), 408(k)(6)(C)(ii), and 501(c)(18). See, e.g., § 1.401(k)-1(g)(7) of this chapter.

(3) *Plan.* The term "plan" means:

(i) A plan described in section 401(a) that includes a trust exempt from tax under section 501(a);

(ii) Any annuity plan described in section 403(a);

(iii) Any annuity contract described in section 403(b);

(iv) A simplified employee pension of an employer that satisfies the requirements of section 408(k); and

(v) A plan described in section 501(c)(18).

The term includes any plan that at any time has been determined by the Secretary to be one of the types of plans described in this paragraph (b)(3).

(c) *No tax when excess distributed within 2½ months of close of year or additional employer contributions made—(1) General rule.* No tax is imposed under this section on any excess contribution or excess aggregate contribution, as the case may be, to the extent the contribution (together with any income allocable thereto) is corrected before the close of the first 2½ months of the following plan year. Qualified nonelective contributions and qualified matching contributions taken into account under § 1.401(k)-1(b)(5) of this chapter or qualified nonelective contributions or elective contributions taken into account under § 1.401(m)-1(b)(5) of this chapter for a plan year may permit a plan to avoid excess contributions or excess aggregate contributions, respectively, even if made after the close of the 2½ month period. See § 1.401(k)-1(f)(1)(i) and (6)(i) of this chapter for methods to avoid excess contributions, and § 1.401(m)-1(e)(1)(i) of this chapter for methods to avoid excess aggregate contributions.

(2) *Tax treatment of distributions.* See § 1.401(k)-1(f)(3)(ii) and (4)(v) of this chapter for rules for determining the tax consequences to a participant of a distribution or recharacterization of excess contributions and income allocable thereto, including a special rule for de minimis distributions. See § 1.401(m)-1(e)(3)(v) of this chapter for rules for determining the tax

consequences to a participant of a distribution of excess aggregate contributions and income allocable thereto.

(3) *Income.* See § 1.401(k)-1(f)(4)(ii) of this chapter for rules for determining income allocable to excess contributions. See § 1.401(m)-1(e)(3)(ii) of this chapter for rules for determining income allocable to excess aggregate contributions.

(4) *Example.* The provisions of this paragraph (c) are illustrated by the following example.

Example. (i) Employer X maintains Plan Y, a calendar year profit-sharing plan that includes a qualified cash or deferred arrangement. Under the plan, failure to satisfy the actual deferral percentage test may only be corrected by distributing the excess contributions or making qualified nonelective contributions (QNECs).

(ii) On December 31, 1990, X determines that Y does not satisfy the actual deferral percentage test for the 1990 plan year, and that excess contributions for the year equal \$5,000. On March 1, 1991, Y distributes \$2,000 of these excess contributions. On May 30, 1991, X distributes another \$2,000 of excess contributions. On December 17, 1991, X contributes QNECs for certain nonhighly compensated employees, thereby eliminating the remainder of the excess contributions for 1990.

(iii) X has incurred a tax liability under section 4979 for 1990 equal to 10 percent of the excess contributions that were in the plan as of December 31, 1990. However, this tax is not imposed on the \$2,000 distributed on March 1, 1991, or the amount corrected by QNECs. X must pay an excise tax of \$200, 10 percent of the \$2,000 of excess contributions distributed after March 15, 1991. This tax must be paid by March 31, 1992.

(d) *Effective date—(1) General rule.* Except as provided in paragraphs (d)(2) through (5), this section is effective for plan years beginning after December 31, 1988.

(2) *Section 403(b) annuity contracts.* In the case of an annuity contract under section 403(b), this section applies to plan years beginning after December 31, 1988.

(3) *Collectively bargained plans and plans of state or local governments.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between an employee representative and one or more employers ratified before March 1, 1986, this section does not apply to years beginning before the earlier of January 1, 1989, or the date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after February 28, 1986). In the case of a plan maintained by a state or local government, the provisions of this

section apply for plan years beginning after December 31, 1988.

(4) *Collectively bargained plans of state or local governments.* Notwithstanding paragraphs (d)(2) and (d)(3) of this section, in the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and state or local governments (ratified before March 1, 1986) or an annuity contract (described in paragraph (d)(2) of this section) under section 403(b) (maintained pursuant to a collective bargaining agreement described in paragraph (d)(3) of this section) the amendments made by this section do not apply to years beginning before the earlier of:

(i) The later of January 1, 1989, or the date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after February 28, 1986); or

(ii) January 1, 1991.

(5) *Plan years beginning before January 1, 1992.* For plan years beginning before January 1, 1992, a reasonable interpretation of the rules set forth in section 4979, as in effect during those years, may be relied upon in determining whether the excise tax is due for those years.

PART 602—OMB CONTROL NUMBER UNDER THE PAPERWORK REDUCTION ACT

Par. 14. The authority citation for part 602 continues to read:

Authority: 28 U.S.C. 7805.

§ 602.101 [Amended]

Par. 15. Section 602.101(c) is amended by inserting in the appropriate place in the table, "§ 1.401(k)-1 * * * 1545-1069 and 1545-1039".

Fred T. Goldberg, Jr.,

Commissioner of Internal Revenue.

Approved: July 23, 1991.

Kenneth W. Gideon,

Assistant Secretary of the Treasury.

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PENSION BENEFIT GUARANTY CORPORATION

29 CFR Part 2676

Valuation of Plan Benefits and Plan Assets Following Mass Withdrawal Interest Rates

AGENCY: Pension Benefit Guaranty Corporation.