

PART III - Administrative, Procedural and Miscellaneous

Cash or Deferred Arrangements; Nondiscrimination

Notice 98-1

I. PURPOSE

This notice provides guidance and transition relief relating to recent statutory amendments to the nondiscrimination rules under § 401(k) and § 401(m) of the Internal Revenue Code. The rules applicable to qualified cash or deferred arrangements under § 401(k) and matching and employee contributions under § 401(m) were amended by the Small Business Job Protection Act of 1996 (SBJPA), Pub. L. 104-188.

Specifically, this notice provides guidance on

- The election to use the current year testing method.
- The use of qualified nonelective contributions (QNCs) and qualified matching contributions (QMACs) under the prior year testing method.
- The application of the first plan year rule under the prior year testing method.
- The impact of certain plan population changes under the prior year testing method.
- A change from the current year testing method to the prior year testing method, including related transition relief.
- Plan amendments needed to reflect the testing method of a plan, including the application of the remedial amendment period under § 401(b).

II. BACKGROUND

A. SBJPA Amendments to § 401(k) and § 401(m)

Under § 401(k) and § 401(m), the actual deferral percentage (ADP) and the actual contribution percentage (ACP) of highly compensated employees (HCEs) are compared with those of nonhighly compensated employees (NHCEs). Section 1433(c) of SBJPA amended § 401(k)(3)(A) and § 401(m)(2)(A), effective for plan years beginning after December 31, 1996, to provide for the use of prior year data in determining the ADP and ACP for NHCEs, while continuing to provide for the use of current year data for HCEs. Alternatively, an employer may elect to use current year data for determining the ADP and ACP for both HCEs and NHCEs, but the

statute provides that this election may be changed only as provided by the Secretary. Section 1433(d) of SBJPA amended § 401(k)(3) and § 401(m)(3) to provide a special rule for determining the ADP and ACP for NHCEs for the first plan year of a plan (other than a successor plan) where the prior year testing method is used.

B. Previous Guidance on the SBJPA Amendments

Notice 97-2, 1997-2 I.R.B. 22, provides guidance on determining the individuals who are taken into account in computing the ADP or ACP for NHCEs for the prior year under the prior year testing method. The guidance provides transition relief to allow plans using the current year testing method for the 1997 testing year to change to the prior year testing method for the 1998 testing year without obtaining approval from the Internal Revenue Service. The notice also provides rules for distributions of excess contributions and excess aggregate contributions.

Notice 97-2 states that Treasury and the Service will issue guidance regarding the conditions under which employers that elect to use current year data for the 1998 or a later plan year may change that election and use prior year testing for subsequent plan years. Notice 97-2 also requested comments concerning (i) the use of QNCs and QMACs in computing the prior year's ADP for NHCEs, including methods of preventing inappropriate double counting; and (ii) the appropriate determination of the prior year's ADP for NHCEs when the group of employees tested is significantly different in the current year than in the prior year. After consideration of the comments received, this notice provides guidance on these issues.

Rev. Proc. 97-41, 1997-33 I.R.B. 51, provides guidance to sponsors of plans that are qualified under § 401(a) with respect to the date by which they must adopt amendments to comply with changes in the law, including a remedial amendment period for amendments to reflect changes to the qualification requirements made by SBJPA.

C. Definitions

If a term that is used in this notice is defined in the regulations under § 401(k) or § 401(m), then the definition under these regulations applies for purposes of this notice. For example, "plan" as used in this notice means plan as defined in § 1.401(k)-1(g)(11) of the Income Tax Regulations.

In addition, for purposes of this notice, the "testing year" is the plan year for which the ADP or ACP for HCEs is being tested; the "prior year" is the plan year immediately preceding the testing year. If the plan uses data from the testing year in

determining the ADP or ACP for NHCEs, it is using the "current year testing method;" if the plan uses data from the prior year in determining the ADP or ACP for NHCEs, it is using the "prior year testing method."

Sections V and VI of this notice provide additional definitions used in applying the first plan year rule and definitions used in the rules relating to changes in the group of eligible employees when a plan uses the prior year testing method.

D. Effect of Statutory Changes on Regulations

Because of the amendments made to § 401(k) and § 401(m), certain portions of § 1.401(k)-1 and §§ 1.401(m)-1 and 1.401(m)-2 no longer reflect current law. This notice provides guidance on a limited number of issues relating to the use of the prior year testing method and relating to a change in testing method. The regulations shall continue in force to the extent that they are not inconsistent with the Code, as amended, and subsequent guidance, including Notice 97-2 and this notice.

III. USE OF CURRENT YEAR TESTING METHOD

As provided under § 401(k)(3)(A) and § 401(m)(2)(A), an employer may elect to use the current year testing method for a plan in lieu of the prior year testing method. A plan using the prior year testing method may adopt the current year testing method for any subsequent testing year. Notification to or filing with the Service of an election to use the current year testing method is not required in order for the election to be valid. However, as provided in section IX of this notice, the plan document governing the plan must reflect whether the plan uses the current year testing method or the prior year testing method for a testing year.

A plan that uses the current year testing method for a testing year may not be permissively aggregated under § 1.410(b)-7(d) with a plan that uses the prior year testing method for that testing year.

IV. USE OF QNCs AND QMACs UNDER PRIOR YEAR TESTING METHOD

Section 401(k)(3)(D) and § 401(m)(3) provide that an employer may take into account QNCs and QMACs in calculating the ADP, and QNCs in calculating the ACP, as provided by the Secretary. A plan may continue to take QNCs and QMACs into account under the prior year testing method, subject to the limitations set forth in section VII.B. of this notice.

A. Timing of Contribution of QNCs and QMACs

In order to be taken into account in the calculation of the ADP or ACP for a year under the prior year testing method, a QNC or QMAC must be allocated as of a date within the year and must actually be paid to the trust no later than the end of the 12-month period following the end of the year to which the contribution relates. See §§ 1.401(k)-1(b)(4)(i)(A) and (b)(5)(v) and §§ 1.401(m)-1(b)(4)(ii) and (b)(5)(iv). Consequently, under the prior year testing method, in order to be taken into account in calculating the ADP or ACP for NHCEs for the prior year, a QNC or QMAC must be contributed by the end of the testing year. Thus, for example, if the prior year testing method is used for the 1998 testing year, QNCs that are allocated to the accounts of NHCEs for the 1997 plan year (i.e., the prior year) must be contributed to the plan by the end of the 1998 plan year in order to be treated as elective contributions for purposes of the ADP test for the 1998 testing year. By contrast, in order to be taken into account in calculating the ADP or ACP for HCEs for the 1998 testing year, a QNC or QMAC must be contributed by the end of the 1999 plan year.

It should be noted that § 1.415-6(b)(7)(ii) provides that, for purposes of satisfying § 415, employer contributions shall not be deemed credited to a participant's account for a particular limitation year unless the contributions are actually made to the plan no later than 30 days after the end of the period described in § 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends. Thus, contributions made after the date described in § 1.415-6(b)(7)(ii) are treated as annual additions for the next § 415 limitation year. Accordingly, under either the prior year testing method or the current year testing method, a violation of § 415(c) might occur if QNCs or QMACs are contributed after the date described in § 1.415-6(b)(7)(ii).

B. Nondiscrimination Testing of QNCs under the Prior Year Testing Method

Section 1.401(k)-1(b)(5) provides that (i) the amount of nonelective contributions, including those QNCs treated as elective contributions for purposes of the ADP test, and (ii) the amount of nonelective contributions, excluding those QNCs treated as elective contributions for purposes of the ADP test, must each satisfy the requirements of § 401(a)(4). Under § 1.401(m)-1(b)(5), a similar rule applies to QNCs treated as matching contributions for purposes of the ACP test.

These nondiscrimination requirements continue to apply to plans that use the prior year testing method. This is true even though the QNCs allocated to the HCEs and NHCEs in a single plan

year are taken into account for ADP and ACP testing in different testing years. Accordingly, QNCs allocated to the accounts of NHCEs and HCEs for the same plan year will be subject to the requirements of § 401(a)(4) for that plan year; however, QNCs allocated to the accounts of HCEs will be taken into account for ADP or ACP testing in the plan year for which they are allocated, while QNCs allocated to the accounts of NHCEs will not be taken into account in determining the permitted ADP or ACP for HCEs until the following plan year.

V. FIRST PLAN YEAR RULE UNDER PRIOR YEAR TESTING METHOD

Section 401(k)(3)(E) provides that, for the first plan year of any plan (other than a successor plan) that uses the prior year testing method, the ADP for NHCEs for the prior year is 3%, or, if the employer elects, is the ADP for NHCEs for that first plan year. For this purpose, the "first plan year" of any plan is the first year in which the plan, within the meaning of § 414(l), is or includes a section 401(k) plan (i.e., the first year a plan provides for elective contributions described in § 1.401(k)-1(g)(3)). However, a plan does not have a first plan year if for such plan year the plan is aggregated under § 1.401(k)-1(g)(11) with any other plan that was or that included a section 401(k) plan in the prior year.

Section 401(m)(3) provides that rules similar to the rules of § 401(k)(3)(E) shall apply for purposes of the ACP test. For purposes of the ACP test, the "first plan year" of any plan is the first year in which a plan, within the meaning of § 414(l), is or includes a section 401(m) plan (i.e., the first year a plan provides for employee contributions described in § 1.401(m)-1(f)(6) or matching contributions described in § 1.401(m)-1(f)(12), or both). However, a plan does not have a first plan year if for such plan year the plan is aggregated for purposes of § 1.401(m)-1(g)(14) with any other plan that was or that included a section 401(m) plan in the prior year.

For purposes of this notice, a plan is a "successor plan" if 50% or more of the eligible employees for the first plan year were eligible employees under another section 401(k) plan (or section 401(m) plan, as applicable) maintained by the employer in the prior year. For example, in 1998, Employer H sponsors Plan T, a section 401(k) plan. In 1999, Employer H establishes Plan U, also a section 401(k) plan, which had 200 eligible employees, including 100 employees who were eligible employees under Plan T in 1998. Plan U is a successor plan.

If a plan (other than a successor plan) uses the prior year testing method and for its first plan year the plan determines the ADP or ACP for NHCEs for the prior plan year using the ADP or ACP for NHCEs for that first plan year (in lieu of 3%), then the use of the prior year testing method in the next testing year is

not treated as a change in testing method. Such a plan would not be subject to the limitations on double counting described in section VII.B. for that next testing year. If a successor plan uses the prior year testing method for its first plan year, the ADP and ACP for NHCEs for the prior year are determined under the rules in section V of this notice.

VI. CHANGES IN THE GROUP OF ELIGIBLE NHCEs WHERE PLAN USES PRIOR YEAR TESTING METHOD

A. General Rule: Disregard Changes in the Group of NHCEs

Except as provided in section VI.B. and C., below, under the prior year testing method, the ADP or ACP for NHCEs for the prior year under a plan is determined without regard to changes in the group of NHCEs who are eligible employees under the plan in the testing year. Thus, under the prior year testing method, the prior year ADP or ACP for NHCEs is used even though some NHCEs may have first become eligible employees under the plan in the testing year because they meet existing plan eligibility requirements, and even though individuals who were eligible employees under the plan and NHCEs in the prior year are no longer employed by the employer or have become HCEs in the testing year.

B. Exception for Plan Coverage Changes

If a plan results from, or is otherwise affected by, a plan coverage change that becomes effective during the testing year, then the ADP and ACP for NHCEs for the prior year under the plan is the weighted average of the ADPs for the prior year subgroups and the weighted average of the ACPs for the prior year subgroups, respectively.

C. Optional Rule for Minor Plan Coverage Changes

If a plan results from, or is otherwise affected by, a plan coverage change, and 90% or more of the total number of NHCEs from all prior year subgroups are from a single prior year subgroup, then in determining the ADP or ACP for NHCEs for the prior year under the plan, an employer may elect to use the ADP and ACP for NHCEs for the prior year of the plan under which that single prior year subgroup was eligible, in lieu of using the weighted averages described in section VI.B., above.

D. Definitions

For purposes of this notice:

1. "Plan coverage change" means a change in the group or groups of eligible employees under a plan on account of (a) the establishment or amendment of a

plan, (b) a plan merger, consolidation, or spinoff under § 414(l), (c) a change in the way plans within the meaning of § 414(l) are combined or separated for purposes of § 1.401(k)-1(g)(11) (e.g., permissively aggregating plans not previously aggregated under § 1.410(b)-7(d), or ceasing to permissively aggregate plans under § 1.410(b)-7(d)), or (d) a combination of any of the foregoing.

2. "Prior year subgroup" means all NHCEs for the prior year who, in the prior year, were eligible employees under a specific section 401(k) plan (or, in the case of the ACP test, a specific section 401(m) plan) maintained by the employer and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the first day of the prior year instead of first being effective during the testing year.
3. "Weighted average of the ADPs for the prior year subgroups" and "weighted average of the ACPs for the prior year subgroups" mean the sum, for all prior year subgroups, of the adjusted ADPs and adjusted ACPs, respectively.
4. "Adjusted ADP" and "adjusted ACP" with respect to a prior year subgroup mean the respective ADP and ACP for NHCEs for the prior year of the specific plan under which the members of the prior year subgroup were eligible employees, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and the denominator of which is the total number of NHCEs in all prior year subgroups.

E. Examples

The requirements of this section VI are illustrated by the following examples:

Example 1:

(i) Employer B maintains two plans, Plan N and Plan P, each of which includes a section 401(k) plan. The plans were not permissively aggregated under § 1.410(b)-7(d) for the 1998 testing year. Both plans use the prior year testing method. Plan N had 300 eligible employees who were NHCEs for 1998, and their ADP for that year was 6%. Plan P had 100 eligible employees who were NHCEs for 1998, and the ADP for those NHCEs for that plan was 4%. Plan N and Plan P are permissively

aggregated under § 1.410(b)-7(d) for the 1999 plan year.

(ii) The permissive aggregation of Plan N and Plan P for the 1999 testing year under § 1.410(b)-7(d) is a plan coverage change that results in treating the plans as one plan (Plan NP) for purposes of § 1.401(k)-1(g)(11). Therefore, the prior year ADP for NHCEs under Plan NP for the 1999 testing year is the weighted average of the ADPs for the prior year subgroups.

(iii) The first step in determining the weighted average of the ADPs for the prior year subgroups is to identify the prior year subgroups. With respect to the 1999 testing year, an employee is a member of a prior year subgroup if the employee (A) was an NHCE of Employer B for the 1998 plan year, (B) was an eligible employee for the 1998 plan year under any section 401(k) plan maintained by Employer B, and (C) would have been an eligible employee in the 1998 plan year under Plan NP if Plan N and Plan P had been permissively aggregated under § 1.410(b)-7(d) for that plan year. The NHCEs who were eligible employees under separate section 401(k) plans for the 1998 plan year comprise separate prior year subgroups. Thus, there are two prior year subgroups under Plan NP for the 1999 testing year: the 300 NHCEs who were eligible employees under Plan N for the 1998 plan year and the 100 NHCEs who were eligible employees under Plan P for the 1998 plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of: (A) the adjusted ADP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N, and (B) the adjusted ADP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P. The adjusted ADP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N is 4.5%, calculated as follows: 6% (the ADP for the NHCEs under Plan N for the prior year) \times 300/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 4.5%. The adjusted ADP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P is 1%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the prior year) \times 100/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 1%. Thus, the prior year ADP for NHCEs under Plan NP for the 1999 testing year is 5.5% (the sum of adjusted ADPs for the prior year subgroups, 4.5% plus 1%).

Example 2:

(i) Employer C maintains a plan, Plan Q, which includes a section 401(k) plan and which uses the prior year testing method. Plan Q covers employees of Division A and Division B. In 1998, Plan Q had 500 eligible employees who were NHCEs, and the ADP for

those NHCEs for 1998 was 5%. Effective January 1, 1999, Employer C spins off a portion of Plan Q under § 414(l), creating a new Plan R which includes a section 401(k) plan in which the 100 employees of Division B are eligible employees.

(ii) The spin-off of Plan R is a plan coverage change that affects Plan Q. Accordingly, for purposes of the 1999 testing year under Plan Q, the prior year ADP for NHCEs under Plan Q is the weighted average of the ADPs for the prior year subgroups. Plan Q has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan Q for the 1998 plan year if the spin-off had occurred as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 1999 testing year under Plan Q, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 5%, the same as if the plan spin-off had not occurred.

Example 3:

(i) The facts are the same as in Example 2, except that instead of spinning off Plan R from Plan Q, Employer C amends the eligibility provisions under Plan Q to exclude employees of Division B effective January 1, 1999. In addition, effective on that same date, Employer C establishes a new plan, Plan R, which includes a section 401(k) plan that uses the prior year testing method. The only eligible employees under Plan R are the 100 employees of Division B who were eligible employees under Plan Q.

(ii) Plan R is a successor plan, within the meaning of section V of this notice (because all of the employees were eligible employees under Plan Q in the prior year), and, therefore, the first plan year rule of that section does not apply.

(iii) The amendment to the eligibility provisions of Plan Q and the establishment of Plan R are plan coverage changes that affect Plan Q and result in Plan R. Accordingly, the prior year ADP for NHCEs under Plan Q is the weighted average of the ADPs for the prior year subgroups. Plan Q has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan Q for the 1998 plan year if the amendment to the Plan Q eligibility provisions had occurred as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 1999 testing year under Plan Q, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 5%, the same as if the plan amendment had not occurred.

(iv) Similarly, Plan R has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan R for the 1998 plan year if the plan were established

as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 1999 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 5%, the same as that of Plan Q.

Example 4:

(i) The facts are the same as in Example 3, except that the provisions of Plan R extend eligibility to 50 hourly employees who previously were not eligible employees under any section 401(k) plan maintained by Employer C.

(ii) Plan R is a successor plan, within the meaning of section V of this notice (because 100 of Plan R's 150 eligible employees were eligible employees under another section 401(k) plan maintained by Employer C in the prior year), and, therefore, the first plan year rule of that section does not apply.

(iii) The establishment of Plan R is a plan coverage change that affects Plan R. Because the 50 hourly employees were not eligible employees under any section 401(k) plan of Employer C for the prior year, they do not comprise a prior year subgroup. Accordingly, Plan R still has only one prior year subgroup. Therefore, for purposes of the 1999 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 5%, the same as that of Plan Q.

VII. CHANGE FROM CURRENT YEAR TO PRIOR YEAR TESTING METHOD

A. General Rule

Section 401(k)(3)(A) provides that if an employer elects to use the current year testing method for purposes of the ADP test, that method may not be changed except as provided by the Secretary. A similar rule applies under § 401(m)(2)(A) in the case of the ACP test. Thus, the statute indicates that once an employer elects to use the current year testing method, the ability to change that election will be limited.

In general, it is expected that plans will select a testing method and retain it. Treasury and the Service recognize, however, that there may be legitimate reasons for occasionally reevaluating and changing the testing method under a plan. In addition, certain business transactions may result in a diversity of testing methods among plans of an employer, and the employer may wish to use consistent testing methods. Finally, Treasury and the Service believe that employers with existing plans should be given a period of time to decide whether to change from the current year testing method (which was the required testing method prior to the SBJPA changes) to the prior year testing

method.

Accordingly, a plan is permitted to change from the current year testing method to the prior year testing method in any of the following situations:

1. The plan is not the result of the aggregation of two or more plans, and the current year testing method was used under the plan for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years the plan has been in existence, including years in which the plan was a portion of another plan).
2. The plan is the result of the aggregation of two or more plans, and for each of the plans that are being aggregated (the aggregating plans), the current year testing method was used for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years since that aggregating plan has been in existence, including years in which the aggregating plan was a portion of another plan).
3. A transaction occurs that is described in § 410(b)(6)(C)(i) and § 1.410(b)-2(f); as a result of the transaction, the employer maintains both a plan using the prior year testing method and a plan using the current year testing method; and the change from the current year testing method to the prior year testing year method occurs within the transition period described in § 410(b)(6)(C)(ii).
4. The change occurs during the plan's remedial amendment period for the SBJPA changes (see Rev. Proc. 97-41).

Notification to or filing with the Service of a change from the current year to the prior year testing method is not required in order for the change to be valid. However, as provided in section IX of this notice, the plan document governing the plan must reflect such a change.

B. Limitations on Double Counting of Certain Contributions

If a plan changes from the current year testing method to the prior year testing method, then, for purposes of the first testing year for which the change is effective, the ADP and ACP for NHCEs for the prior year is determined in the following manner:

1. The ADP for NHCEs for the prior year is determined taking into account only (a) elective contributions for those NHCEs that were taken into account for purposes of the ADP test (and not the ACP test) under the current year testing method for the prior year and (b) QNCs that were allocated to the accounts of those NHCEs for the prior year but that were not used to satisfy the ADP test or the ACP test under the current year testing method for the prior year.
2. The ACP for NHCEs for the prior year is determined taking into account only (a) employee contributions for those NHCEs for the prior year, (b) matching contributions for those NHCEs that were taken into account for purposes of the ACP test (and not the ADP test) under the current year testing method for the prior year, and (c) QNCs that were allocated to the accounts of those NHCEs for the prior year but that were not used to satisfy the ACP test or the ADP test under the current year testing method for the prior year.

Thus, in determining the ADP for NHCEs for the prior year, the following contributions made for the prior testing year are disregarded: QNCs used to satisfy either the ADP or ACP test under the current year testing method for the prior testing year, elective contributions taken into account for purposes of the ACP test, and all QMACs. Similarly, in determining the ACP for NHCEs for the prior year, the following contributions made for the prior testing year are disregarded: QNCs used to satisfy either the ADP or ACP test under the current year testing method for the prior testing year, QMACs taken into account for purposes of the ADP test, and all elective contributions.

The limitations on double counting under this section VII.B. do not apply for testing years beginning before January 1, 1999. Accordingly, in the case of a plan that changes from the current year to the prior year testing method for the first time for either the 1997 or 1998 testing year, the ADP and ACP for NHCEs used for that testing year are the same as the ADP and ACP, respectively, for NHCEs used for the prior testing year.

3. Examples

The limitations on double counting are illustrated by the following examples:

Example 1:

- (i) Employer A established Plan M, a calendar year section 401(k) plan, in 1993 and, through the 2000 testing year, has

always used the current year testing method under Plan M. The ADP for the HCEs under Plan M is 7% for the 2000 testing year. Based solely on elective contributions by NHCEs under Plan M for the 2000 testing year, the ADP for NHCEs for the 2000 testing year is 4%. In order to satisfy the ADP test, Employer A provides a QNC to each NHCE for the 2000 testing year equal to 1% of compensation. No other contributions under Plan M are taken into account in determining the ADP for NHCEs. Thus, the ADP for NHCEs for the 2000 testing year is 5%. Plan M is amended to use the prior year testing method instead of the current year testing method for purposes of the ADP test for the 2001 testing year.

(ii) In determining the ADP for NHCEs under Plan M for the 2001 testing year in accordance with the prior year testing method, the elective contributions made by NHCEs under Plan M for the 2000 plan year are taken into account. However, the QNCs equal to 1% of compensation made under Plan M on behalf of NHCEs for the 2000 plan year are disregarded because they were used to satisfy the ADP test for the 2000 testing year. Thus, for purposes of the 2001 testing year, the ADP for NHCEs for the prior year is 4% (unless additional QNCs for NHCEs are timely contributed and allocated for the 2000 plan year).

Example 2:

(i) The facts are the same as in Example 1, except that the testing years are 1997 and 1998, instead of 2000 and 2001.

(ii) For purposes of the 1998 testing year, the ADP for NHCEs for the prior year is 5%. The QNCs equal to 1% of compensation made under Plan M on behalf of NHCEs that were used to satisfy the ADP test for the 1997 testing year are not disregarded because the limitation on double counting applies only for testing years beginning on or after January 1, 1999.

VIII. ANTI-ABUSE PROVISION

This guidance is designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the prior year ADP and ACP for NHCEs (which are used as benchmarks for testing the ADP and ACP for HCEs). Further, the ADP and ACP tests are part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the ADP or ACP test if there are repeated changes in plan testing procedures or plan provisions that have the effect of distorting the ADP or ACP test so as to increase

significantly the permitted ADP or ACP for HCEs and if a principal purpose of the changes was to achieve such a result.

IX. PLAN PROVISIONS REGARDING TESTING METHOD

Sections 1.401(k)-1(b)(2)(iii) and 1.401(m)-1(b)(2) require that a plan to which § 401(k) or § 401(m) applies must provide that the ADP or ACP test will be met. Because a plan may now use either the current year testing method or the prior year testing method, a plan must specify which of these two testing methods it is using. If the employer changes the testing method under a plan, the plan must be amended to reflect the change. Further, if the first plan year rule described in § 401(k)(3)(E) and § 401(m)(3) and section V of this notice applies, a plan that incorporates these provisions by reference must specify whether the ADP and ACP for NHCEs for the prior plan year is 3% or the current year's ADP and ACP for the NHCEs.

The regulations under § 401(k) and § 401(m) permit a plan to incorporate by reference § 401(k)(3) and § 401(m)(2) (and, if applicable, § 401(m)(9)) and the specific underlying regulations. A plan that incorporates these provisions by reference must continue to refer to the applicable Code sections and the specific underlying regulations, must specify which of the two testing methods (prior year or current year) it is using, and must now provide that it is incorporating by reference subsequent Internal Revenue Service guidance issued under the applicable Code provisions. Further, for purposes of the first plan year rule described in § 401(k)(3)(E) and § 401(m)(3) and section V of this notice, a plan that incorporates these provisions by reference must specify whether the ADP and ACP for NHCEs for the prior plan year is 3% or the current year's ADP and ACP for the NHCEs.

Rev. Proc. 97-41 provides that qualified retirement plans have a remedial amendment period under § 401(b) so that certain plan amendments for SBJPA generally are not required to be adopted before the last day of the first plan year beginning on or after January 1, 1999. Pursuant to Rev. Proc. 97-41, a plan provision reflecting the ADP or ACP testing method is a disqualifying provision, and thus any plan amendments to reflect a choice in testing method are not required to be adopted until the end of this remedial amendment period. However, plans must be operated in accordance with the SBJPA changes to § 401(k)(3)(A) and § 401(m)(2)(A) as of the statutory effective date. In addition, under Rev. Proc. 97-41, any retroactive amendments must reflect the choices made in the operation of the plan for each testing year, including the choice of testing method (and any changes to that election), and must reflect the date on which the plan began to operate in accordance with those choices (and any such changes).

X. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1579.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this notice is in section IX. This requirement to amend plan documents is necessary to reflect the new nondiscrimination test under § 401(k)(3) and § 401(m)(2) as amended by SBJPA. The pre-SBJPA method of nondiscrimination testing is still available under these Code sections and a plan amendment may not be required to reflect the choice of the pre-SBJPA testing method. The information will be used to determine whether the ADP and ACP of HCEs exceeds the ADP and ACP of NHCEs by more than the statutory limits. The collection of information is required to obtain a benefit. The likely respondents are businesses or other for-profit institutions, and nonprofit institutions.

The estimated total annual recordkeeping burden is 49,000 hours. The estimated annual burden per recordkeeper is 20 minutes. The estimate number of recordkeepers is 147,000.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

XI. COMMENTS

Treasury and the Service invite comments regarding the matters discussed in this notice. Comments may be submitted to the Service at CC:DOM:CORP:R (Notice 98-1), Room 5226, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Alternatively, taxpayers may hand-deliver comments between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97-XX), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., or may submit comments electronically via the Service's Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

Drafting Information

The principal authors of this notice are Susan Lennon of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations) and Roger Kuehnle of the Employee Plans

Division. For further information regarding this notice, contact the Employee Plans Division's telephone assistance service between 1:30 and 4:00 p.m., Eastern Time, Monday through Thursday at (202) 622-6074/75. (These telephone numbers are not toll-free.)