



determining the ADP and ACP of NHCEs, while current year data is used for HCEs. Alternatively, an employer may elect to use current year data for determining the ADP and ACP for both HCEs and NHCEs, but this election may only be changed as provided by the Secretary. Prior to the effective date of these amendments, plans must use current year data in determining the ADP and ACP for both HCEs and NHCEs.

Section 1433(e) of the SBJPA amends § 401(k)(8)(C) and § 401(m)(6)(C), effective for plan years beginning after December 31, 1996, to provide that the distribution of excess contributions and excess aggregate contributions will be made on the basis of the amount of contributions by, or on behalf of, each HCE. Prior to the effective date of these amendments, plans must distribute excess contributions and excess aggregate contributions using a method based on the actual deferral ratio or actual contribution ratio of each HCE.

This notice provides guidance regarding the determination of the ADP and ACP for NHCEs under § 401(k)(3)(A)(ii) and § 401(m)(2)(A) for plan years beginning after December 31, 1996; transition relief for plans that elect to use current year ADP or ACP data for the 1997 plan year; and guidance regarding the distribution of excess contributions and excess aggregate contributions under § 401(k)(8)(C) and § 401(m)(6)(C) for plan years beginning after December 31, 1996.

I. DETERMINATION OF ADP AND ACP FOR NHCEs USING PRIOR YEAR DATA

Section 401(k)(3)(A)(ii), as amended, provides that a cash or deferred arrangement will not be treated as a qualified cash or deferred arrangement unless the actual deferral percentage for eligible HCEs for the plan year meets a nondiscrimination test when compared to the actual deferral percentage for all other eligible employees for the preceding plan year. Thus, as amended, § 401(k)(3)(A)(ii) generally requires the comparison of the current year's ADP for HCEs to the prior year's ADP for NHCEs.

For purposes of § 401(k)(3)(A)(ii), the actual deferral percentage for all other eligible employees for the preceding plan year is the ADP for the preceding plan year for the group of employees who were NHCEs in the preceding

plan year, using the definition of HCE in effect for the preceding plan year. Thus, for purposes of § 401(k)(3)(A)(ii), the individuals taken into account in determining the prior year's ADP for NHCEs are those individuals who were NHCEs during the preceding year, without regard to the individuals' status in the current year. For example, an individual who was an NHCE for the preceding plan year is included in this calculation even if the individual is no longer employed by the employer or has become an HCE in the current plan year.

As a result, the prior year's ADP for NHCEs can be calculated as soon as the necessary data on prior year status, contributions and compensation become available. For example, for the 1997 plan year, if a plan does not provide for matching contributions described in § 401(m)(4)(A) or qualified nonelective contributions described in § 401(m)(4)(C), the ADP for the 1997 plan year of HCEs will be compared with the ADP for the 1996 plan year of NHCEs in 1996, i.e., with the same ADP used in nondiscrimination testing for the 1996 plan year under prior law. Future guidance will address the conditions under which and the extent to which matching contributions described in § 401(m)(4)(A) and qualified nonelective contributions described in § 401(m)(4)(C) may be taken into account in determining the current or prior year's ADP or ACP for NHCEs in nondiscrimination testing for the 1997 plan year and future plan years.

For purposes of determining the prior year's ACP for NHCEs under § 401(m)(2)(A), as amended, rules similar to those used in determining the prior year's ADP for NHCEs under § 401(k)(3)(A)(ii) will apply.

II. TRANSITION RELIEF FOR PLANS USING CURRENT YEAR ADP OR ACP DATA FOR THE 1997 PLAN YEAR

Under § 401(k)(3)(A)(ii) and § 401(m)(2)(A), as amended, an employer that elects to use current year data in determining the ADP or ACP of NHCEs for the 1997 plan year or for later plan years must continue to use current year data for all future plan years, unless the election is changed in a manner provided by the Secretary.

Under the transition relief provided by this notice, a plan that uses current

Cash or Deferred Arrangements; Nondiscrimination

Notice 97-2

This notice provides guidance and transition relief relating to the revised 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 changed by the Small Business Job Protection Act of 1996 (SBJPA), Pub. L. 104-188.

Under § 401(k) and § 401(m) of the Code, 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 the SBJPA amends § 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

year data in determining the ADP or ACP of NHCEs for the 1997 plan year will be permitted to use prior year data for the 1998 plan year without receiving approval from the Service. For the 1997 plan year, no plan amendment or formal election is required to be made in 1996 or 1997 in order to continue to use current year data in determining the ADP of NHCEs. The Treasury and the Service intend to issue guidance regarding the conditions under which employers that elect to use current year data for the 1998 or a later plan year may switch to using prior year data for subsequent plan years.

III. DISTRIBUTION OF EXCESS CONTRIBUTIONS AND EXCESS AGGREGATE CONTRIBUTIONS

Section 401(k)(8), as amended, provides a new procedure for correcting a plan's failure to meet the nondiscrimination test of § 401(k)(3). Under § 401(k)(8)(B), which was not amended by the SBJPA, an excess contribution is determined for each HCE. Section 401(k)(8)(C), prior to amendment, and § 1.401(k)-1(f)(2) of the Income Tax Regulations provided for the distribution of this amount to each HCE. Parallel rules applied to correction of failure to satisfy the nondiscrimination test of § 401(m).

The SBJPA amended § 401(k)(8)(C) to provide that distributions of excess contributions for any plan year are made to HCEs on the basis of the amount of contributions by, or on behalf of, each HCE. This amendment does not affect the total amount of the excess contributions to be distributed, but merely reallocates the distributions among the HCEs.

Accordingly, in order to distribute excess contributions under § 401(k)(8), as amended, the following procedure is used:

1. Calculate the dollar amount of excess contributions for each affected HCE in a manner described in § 401(k)(8)(B) and § 1.401(k)-1(f)(2). However, in applying these rules, rather than distributing the amount necessary to reduce the actual deferral ratio (ADR) of each affected HCE in order of these employees' ADRs, beginning with the highest ADR, the plan uses these amounts in step 2.
2. Determine the total of the dollar amounts calculated in step 1.

This total amount in step 2 (total excess contributions) should be distributed in accordance with steps 3 and 4 below:

3. The elective contributions of the HCE with the highest dollar amount of elective contributions are reduced by the amount required to cause that HCE's elective contributions to equal the dollar amount of the elective contributions of the HCE with the next highest dollar amount of elective contributions. This amount is then distributed to the HCE with the highest dollar amount. However, if a lesser reduction, when added to the total dollar amount already distributed under this step, would equal the total excess contributions, the lesser reduction amount is distributed.
4. If the total amount distributed is less than the total excess contributions, step 3 is repeated.

If these distributions are made, the cash or deferred arrangement is treated as meeting the nondiscrimination test of § 401(k)(3) regardless of whether the ADP, if recalculated after distributions, would satisfy § 401(k)(3).

A parallel method is used for the purpose of recharacterizing excess contributions under § 401(k)(8)(A)(ii) and for distributing excess aggregate contributions under § 401(m)(6)(C), as amended.

After excess and excess aggregate contributions, if any, have been distributed using the method described above, the multiple use test of § 401(m)(9) is applied. For purposes of § 401(m)(9), if a corrective distribution of excess contributions has been made, or a recharacterization has occurred, the ADP for HCEs is deemed to be the largest amount permitted under § 401(k)(3). Similarly, if a corrective distribution of excess aggregate contributions has been made, the ACP for HCEs is deemed to be the largest amount permitted under § 401(m)(2).

The method described above for distributing excess contributions is illustrated by the following example:

For the 1997 plan year, HCE 1 has elective contributions of \$8,500 and \$85,000 in compensation, for an ADR of 10%, and HCE 2 has elective contributions of \$9,500 and compensation of \$158,333, for an ADR of 6%. As a result, the ADP for the 2 HCEs under the plan (HCE 1 and HCE 2) is 8%. The ADP for the NHCEs is 3%. Under the ADP test of § 401(k)(3)(A)(ii), the

ADP of the two HCEs under the plan may not exceed 5% (i.e., 2 percentage points more than the ADP of the NHCEs under the plan).

Pursuant to § 401(k)(8)(B), § 1.401(k)-1(f)(2), and this notice, the total excess contributions for the HCEs is determined as follows:

Step 1. The elective contributions of HCE 1 (the HCE with the highest ADR) are reduced by \$3,400 in order to reduce the ADR of HCE 1 to 6% (\$5,100/\$85,000), which is the ADR of HCE 2. Because the ADP of the HCEs still exceeds 5%, the ADP test of § 401(k)(3)(A)(ii) is not satisfied and further reductions in elective contributions are necessary. The elective contributions of HCE 1 and HCE 2 are each reduced by one percent of compensation (\$850 and \$1,583 respectively). Because the ADP of the HCEs now equals 5%, the ADP test of § 401(k)(3)(A)(ii) is satisfied, and no further reductions in elective contributions are necessary.

Step 2. The total excess contributions for the HCEs that must be distributed equal \$5,833, the total reductions in elective contributions under step 1 (\$3,400 + \$850 + \$1,583).

Pursuant to § 401(k)(8)(C), the \$5,833 in total excess contributions for the 1997 plan year would then be distributed as follows:

Step 3. The plan distributes \$1,000 in elective contributions to HCE 2 (the HCE with the highest dollar amount of elective contributions) in order to reduce the dollar amount of the elective contributions of HCE 2 to \$8,500, which is the dollar amount of the elective contributions of HCE 1.

Step 4. Because the total amount distributed (\$1,000) is less than the total excess contributions (\$5,833), step 3 must be repeated. As the dollar amounts of remaining elective contributions for both HCE 1 and HCE 2 are equal, the remaining \$4,833 of excess contributions is then distributed equally to HCE 1 and HCE 2 in the amount of \$2,416.50 each.

Under this example, HCE 1 must receive a total distribution of \$2,416.50 of excess contributions, and HCE 2 must receive a total distribution of \$3,416.50 of excess contributions. This is true even though the ADR of HCE 1 exceeded the ADR of HCE 2. The plan is now treated as satisfying the nondiscrimination test of § 401(k)(3) even

though the ADP would fail to satisfy § 401(k)(3), if recalculated after distributions.

COMMENTS REQUESTED

The Treasury and the Service invite comments and suggestions regarding the matters discussed in this notice. Comments are specifically requested concerning:

—The use of qualified matching and qualified nonelective contributions in computing the prior year's ADP for NHCEs, including methods of preventing inappropriate double counting.

—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.

Comments can be addressed to CC:DOM:CORP:R (Notice 97-2), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97-2), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments/html.

DRAFTING INFORMATION

The principal authors of this notice are Kenneth Conn of the Employee Plans Division and Catherine Fernandez of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). 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 or Kenneth Conn at (202) 622-6214. (These telephone numbers are not toll-free numbers.)