

Pension ANALYST



Important Information

Plan Administration and Operation

January 1997*

IRS Issues Rules for Computing ACP/ADP Using Prior Year Data and for Making Corrective Distributions

WHO'S AFFECTED These rules apply to defined contribution plans with a 401(k) feature, employer matching contributions and/or post-tax employee contributions, and defined benefit plans with an attached VIP that must satisfy the actual deferral percentage (ADP) test and/or the actual contribution percentage (ACP) test each year.

BACKGROUND AND SUMMARY Legislation enacted in 1996 allows qualified plans to perform the ADP and ACP tests using the ADP and ACP of the non-highly compensated employees (NHCEs) for the prior year and the ADP and ACP for highly compensated employees (HCEs) for the current year. This provision is effective for plan years beginning after December 31, 1996. For example, for 1997 plan year ADP testing, employers may use the ADP of the NHCEs that was determined for the 1996 plan year. Employers still have the option to use current year data for both NHCEs and HCEs. However, once an employer makes the election to use current year data for both NHCEs and HCEs, it can only be changed according to procedures yet to be announced by the Secretary of the Treasury.

There is a transition rule, however, that allows plans to use current year ADP or ACP data for the 1997 plan year for both NHCEs and HCEs and, without receiving approval, to use prior year NHCE data for the 1998 plan year.

Note: For 1996 Plan Year ADP and ACP testing, plans must use current year NHCE and HCE data.

ACTION AND NEXT STEPS Plan sponsors must decide whether to continue to use current year data for ADP and ACP testing or whether to use prior year NHCE data when performing their ADP and ACP test for their 1997 plan year. If you have purchased CIGNA's testing service, you will have to tell us which choice you have made when you provide us with the data to perform your 1997 plan year test as well as any midyear checkpoint test.

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The SBJPA Has Amended the Nondiscrimination Rules

For plan years beginning after December 31, 1996, the Small Business Job Protection Act of 1996 (SBJPA '96) amended the section 401(k) and section 401(m) nondiscrimination rules. Under sections 401(k) and 401(m), the actual deferral percentage (ADP) and the actual contribution percentage (ACP) of highly compensated employees (HCEs) is compared to that of nonhighly compensated employees (NHCEs). To meet the nondiscrimination requirements, the percentages of the two groups must not differ by more than a prescribed amount.

Under the SBJPA '96, the ADP and ACP of NHCEs for current year testing may be determined using prior year data. In addition, if the HCEs have excess contributions (ADP excesses) or excess aggregate contributions (ACP excesses), the new law provides that corrective distributions will be made on the basis of *the amount* of the contributions made by, or on behalf of, each HCE. In the past, these corrections were based solely on the deferral or contribution ratios of the HCEs.

Many questions arose regarding how these provisions would be applied. The IRS has answered some of these questions in Notice 97-2.

Determining Current Year Allowable ADP or ACP for HCEs

To determine the allowable ADP or ACP for HCEs in the current year, a comparison is made to the ADP or ACP of all other eligible employees in the preceding year. The ADP or ACP of all other eligible employees in the preceding year is the ADP or ACP of NHCEs in the preceding year, using the definition of HCE in effect in that preceding year. It does not matter what the employee's status is (e.g., HCE or NHCE) in the current year or whether he/she is still employed by the employer in the current year. An employee who was an NHCE last year, and whose ADP or ACP for last year was used to determine the allowable percentage for HCEs this year, could, in fact, be an HCE this year and be subject to the ADP limit he or she helped establish as an NHCE last year.

Correcting ADP Excesses

Correction of ADP excesses is a multi-step process that is ultimately based on the amount of the contributions made by each HCE. The process is a combination of the old law leveling by percentage and the new law leveling by amount.

First Level by Percentage

- Step 1. Calculate the dollar amounts of excesses for each HCE as would be done under "old" rules; i.e., reduce (level) the deferral percentages beginning with the HCE with the highest percentage and work down to the next highest percentage until the acceptable total percentage is reached.
- Step 2. Determine the total dollar amount that would be refunded based on Step 1.

Then Level by Dollar Amount

- Step 3. Reduce the elective contributions of the HCE with the highest dollar amount of elective deferrals by an amount so that the HCE's contributions are equal in dollar amount to those of the HCE with the next highest dollar amount of contributions.
- Step 4. If the total dollar amount described in Step 3 is less than the total dollar amount that needs to be refunded (as calculated in Step 2), the process is continued by bringing the HCEs' dollar amount of contributions (in Step 3) down to the level of the HCE with the next highest dollar amount of contributions. This process is continued until the full amount of the correction (as calculated in Step 2) has been reached.

A parallel method is used for distributing ACP excesses.

The IRS is soliciting comments on the use of Qualified Matching Contributions (QMACs) and Qualified Nonelective Contributions (QNECs) in calculating the prior year's ADP for NHCEs and how to determine the prior year's ADP for the NHCE group when the group of employees tested has changed significantly between the prior year and the current year.

Below is an example to illustrate how the new leveling works. This example does not provide for either QMACs or QNECS.

Employee	Contributions	Compensation	ADR*	ADP
HCE 1	\$ 8,500	\$ 85,000	10%	
HCE 2	\$ 9,500	\$158,333	6%	
HCE Group				8%
NHCE Group				3%

*ADR = actual deferral ratio
 Maximum HCE ADP = 5%

- Step 1. Reduce HCE 1's ADR to 6% (= HCE 2's ADR). This reduction = \$3,400.
 Reduce both HCE 1's ADR and HCE 2's ADR to 5% each (= 5% ADP).
 HCE 1's additional reduction = \$850.
 HCE 2's reduction = \$1,583.
- Step 2. Total dollar amount of reductions needed = \$3,400 + \$850 + \$1,583 = \$5,833.
 Determine distributions as follows:
- Steps 3, 4, etc.

	HCE 1		HCE 2	
	Contributions	Distribution	Contributions	Distribution
Original	\$ 8,500.00		\$ 9,500.00	
Step 3				\$ 1,000.00
Balance	\$ 8,500.00		\$ 8,500.00	
Step 4		\$ 2,416.50		\$ 2,416.50
Balance	\$ 6,083.50		\$ 6,083.50	
Corrective Distributions		\$ 2,416.50		\$3,416.50

	HCE 1	HCE 2	Total
Corrective Distributions	\$2,416.50	\$3,416.50	\$5,833.00
Original Reductions	\$4,250.00	\$1,583.00	\$5,833.00

Pension Analyst by Prudential Retirement

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