Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:ILD:CHI:TL-N-7450-98
LHAckerman

date: JAN 15 1999

to: Timothy Lambin, Group Manager, EP: 7103

from: District Counsel, Illinois District

subject: [redacted]
Request for Legal Advice and Assistance

You requested our review and comments regarding two issues which arose during the examination of [redacted]. The first issue concerns the requirement that participants defer either [redacted] or [redacted] percent of their compensation into the [redacted] Employees' Savings and Profit Sharing Plan (the plan) as long as they are employed by [redacted]. Participants may in addition defer up to 15 percent of their compensation into the plan. However, participants may not elect to defer zero percent of their compensation and receive their full compensation in cash.

We have reviewed your submission, including the plan document, and relevant provisions of the Internal Revenue Code and regulations. We conclude that the first [redacted] percent of compensation which participants are required to defer does not constitute an elective contribution or a qualified nonelective contribution, but rather is a mandatory employee contribution which can only be made to the plan on an after-tax basis.

Treasury regulation §1.401(k)-1(g)(3) defines elective contributions, stating:

> [t]he 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.

Thus, in order to be an elective contribution, a contribution must have been made pursuant to a cash or deferred election. Treasury regulation § 1.401(k)-1(a)(3)(i) defines a cash or deferred election as "any election (or modification of an earlier election) by an employee to have the employer 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." Accordingly, in order for an amount to be subject to a cash or deferred election it cannot be currently available to the employee. In addition, however, the amount must become currently available to the employee if no cash or deferred election is made. Treas. Reg. §1.401(k)-1(a)(3)(ii). With respect to [redacted]'s plan, the first one percent of plan participants' compensation would not become currently available but for the election, because participants are required to defer the first one percent of compensation as a condition of employment. Thus, this money cannot be subject to a cash or deferred election and accordingly cannot be considered to be elective contributions.

In response to your IDR #EP-038, [redacted], by way of its legal counsel [redacted], has stated that the [redacted] percent contributions are, in actuality, nonelective employer contributions. Furthermore, they submit that because the contributions are nonforfeitable and subject to the distribution requirements applicable to elective contributions, the [redacted] percent contributions are qualified nonelective contributions.

The flaw in this argument is that the one percent contributions are funded by a reduction in salary and as such are employee contributions. The most basic requirement of a qualified nonelective contribution is that it be an employer contribution. Treas. Reg. § 1.401(k)-1(g)(13)(ii). While the 401(k) regulations do not define employer versus employee contributions, they do provide for the "treatment" of elective contributions as employer contributions. Treasury Regulation 1.401(k)-1(a)(4)(ii) provides that "except as provided in paragraph (f) of this section, elective contributions under a qualified cash or deferred arrangement are treated as employer contributions." There would be no need to "treat" them as employer contributions, if they were in fact employer contributions. Rather, this deeming rule is necessary because a contribution which is funded by salary reduction is the essence of an employee contribution.

Further support for this conclusion is contained in the vesting provisions of Code section 411. As a condition of qualification, a plan is required to provide that an employee's rights in his accrued benefit derived from his own contributions are nonforfeitable. I.R.C. § 411(a)(1). Mandatory employee contributions are counted as part of the accumulated contributions of an employee which comprise the accrued benefit derived from employee contributions. Code section 411 provides that:

> For purposes of this subparagraph, the term "mandatory contributions" means amounts contributed to the plan by the employee which are required as a condition of employment, as a condition of participation in such plan, or as a condition of obtaining benefits under the plan attributable to employer contributions.

I.R.C. § 411(c). The [redacted] [redacted] percent contribution is required as a condition of participation according to the plan language (plan paragraph 3.1(a)) and as a condition of employment according to the Summary Plan Description (page 25). As such it is a mandatory employee contribution which is nonforfeitable as a requirement of Code section 411, and not in satisfaction of the requirements of qualified nonelective contributions.

The [redacted] [redacted] percent contribution constitutes a mandatory employee contribution, which because it is not an elective contribution, remains an employee contribution and is not deemed to be an employer contribution pursuant to Treas. Reg. 1.401(k)-1(a)(4)(ii). Accordingly, [redacted] may not avail itself of the preferred exclusion from income treatment accorded elective deferrals by I.R.C. § 402(e)(3), and the [redacted] percent contribution must be included in the employees' gross income. As an employee contribution, the [redacted] percent contribution should be counted in running the actual contribution percentage test (ACP) and not the actual deferral percentage test (ADP). See Treas. Reg. 1.401(m)-1(f)(1) and (6). Thus, the employer should demonstrate its ability to pass both tests, counting the [redacted] percent contribution only for ACP test purposes.

In the event the CODA portion of the plan fails the ADP test, it becomes a nonqualified cash or deferred arrangement. When a CODA becomes non-qualified the income exclusion for the deferrals is lost. The amounts deferred will be considered to be taxable in the tax year for which the deferrals were made. Treas. Reg. § 1.401(k)-1(a)(5)(iii). (They are deductible by the employer as employer contributions under I.R.C. § 404.)

When a CODA is no longer qualified there is an increased chance the plan as a whole will fail to satisfy I.R.C. § 410(b). A non-qualified CODA is tested together with the rest of the plan for coverage. Employees who deferred $0, even though they were eligible to make deferrals, are no longer counted as "benefitting" under the plan for I.R.C. § 410(b) purposes unless they received other employer contributions. This is in contrast to the relaxed I.R.C. § 410(b) coverage test that applies to a qualified CODA. The qualified CODA is tested for I.R.C. § 410(b) coverage separate from the rest of the plan and it is permitted to count as "benefitting" everyone who is eligible to make elective contributions under the plan, even if in fact the individuals defer $0.

Also, once it is disqualified, the CODA portion of the plan can no longer pass I.R.C. § 401(a)(4) non-discrimination by satisfying ADP. Rather, a disqualified CODA must satisfy the regular I.R.C. § 401(a)(4) rules counting the elective deferrals as employer contributions. Usually this will result in the non-qualified CODA applying the general test of I.R.C. § 401(a)(4), i.e., rate groups.

If the IRS disqualifies a CODA, but not the plan as a whole, the examiner is required to set up discrepancy adjustments for inclusion in income of all deferrals made by participants in open tax years. EP managers can authorize that discrepancy adjustments be set up against highly compensated employees only. Pursuant to Rev. Proc. 98-22, 1998-12 I.R.B. 1, these discrepancy adjustments can be the subject of a closing agreement within the authority of the EP Key District office. Revenue Procedure 98-22 provides that the audit closing agreement program (audit CAP) is available for all types of qualification failures found on examination that cannot be corrected under the administrative policy regarding self-correction (APRSC). Audit CAP covers operational failures as one type of qualification failure. Operational failures consist of qualification failures which arise solely from the failure to follow plan provisions and include the failure to satisfy the requirements of I.R.C. §§ 401(k) and 401(m) as those requirements are provided in the terms of the plan.

The second issue which you raise concerns the discrepancy between the plan's language and the employer's actual practice concerning the [redacted] percent contributions. We agree with your analysis that the actual terms of the plan do not require all employees to make the [redacted] percent contribution, but rather it requires all participants to do so. The plan does not require all employees to become participants upon hiring. To the contrary, the plan imposes a one year of service requirement on employees to become eligible to participate in the plan, except for the Salary Investment Account feature. Accordingly, with respect to the plan's practice of requiring all employees (as opposed to all participants) to defer [redacted] percent of compensation the plan does not have reliance on the June 9, 1994, determination letter.

If you have any questions, please contact Lawrence H. Ackerman at (312) 886-9225 x 334.

RICHARD A. WITKOWSKI
District Counsel

By: Judith M. Picken
JUDITH M. PICKEN
Assistant District Counsel