

NONDISCRIMINATION TESTING OVERVIEW

ADP/ACP TESTING

Overview The ADP and ACP tests are performed to ensure that Highly Compensated Employees (HCEs) do not derive a much greater benefit from a qualified plan than Non-Highly Compensated Employees (NHCEs).

When these tests are performed The testing date for both ADP and ACP testing is the last day of the plan year.

Definition: Actual Deferral Percentage (ADP) Test The Actual Deferred Percentage (ADP) Test measures the rate of 401(k) elective deferrals.

The ADP for each group of employees (HCEs and NHCEs) is the average Actual Deferral Ratio (ADR) of all employees in the group.

(Each eligible employee's ADR = 401(k) elective deferral divided by plan compensation (Full or Partial (A))).

Example: If a participant has 401(k) elective deferrals of \$6,000 and plan compensation of \$75,000, the participant's ADP = $\$6,000/\$75,000 = 8.00\%$.

Definition: Actual Contribution Percentage (ACP) Test The Actual Contribution Percentage (ACP) Test measures the rate of employer matching and after-tax contributions.

The ACP for each group of employees (HCEs and NHCEs) is the average Actual Contribution Ratio (ACR) of all employees in the group.

(Each eligible employee's ACR = employer matching contributions plus employee after-tax contributions (if any) divided by plan compensation (Full or Partial Year (A) or (B))).

Example: If a participant has employer matching contributions of \$3,000 and plan compensation of \$75,000, the participant's ACP = $\$3,000/\$75,000 = 4.00\%$.

ADP Test standards The ADP of HCEs cannot exceed the greater of:

- 1.25 times the ADP of the NHCEs (***1.25 Test***) or
 - the lesser of:
 - 2 plus the percentage points of the ADP of the NHCEs or
 - 2 times the ADP of the NHCEs (***Plus 2/Times 2 Test***).
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ACP Test standards

The ACP of the HCEs cannot exceed the greater of:

- 1.25 times the ACP of the NHCEs (*1.25 Test*) or
- the lesser of:
 - 2 plus the percentage points of the ACP of the NHCEs or
 - 2 times the ACP of the NHCEs (*Plus 2/Times 2 Test*).

415 ANNUAL ADDITIONS LIMITATION TESTING

Overview

The 415 Limit Test is performed to ensure that the total of each participant's contributions and deferrals has not exceeded the Annual Additions limit as defined in Internal Revenue Code Section 415.

415 Limit Test standards

The total annual additions (employee contributions plus employer contributions (including any forfeiture reallocations)) to each participant's account cannot exceed the lesser of:

- 100% of 415 compensation or
- \$40,000

2002 DOLLAR LIMITS

IRC §415(c)(1)(A) dollar limitation-defined contribution plans	\$ 40,000
IRC §402(g)(1) limitation for 401(k) and 403(b) elective deferrals	\$ 11,000
IRC §401(k)(11)(B)(i)(I) SIMPLE retirement account elective deferral limit	\$ 7,000
IRC §401(a)(17) annual compensation limitation	\$ 200,000*
Social Security Taxable Wage Base	\$ 84,900

* If your plan was transitioned to AUL in 2002 and a customized good faith amendment was prepared for your adoption agreement, the compensation limit may be \$170,000 or some lesser amount. Please review the EGTRRA amendment that was prepared for your plan.

Sample ADP Test

Test Results Page

Valuation as of December 31, 2002

IRC 401(k) ADP Test

SALARY GROUP	NUMBER OF PARTICIPANTS	AVERAGE* DEFERRAL AS % PAY
Highly Compensated	1	6.00%
Non-Highly Compensated	3	2.00%
Total Plan	4	3.00%

HCEs Avg ADP % = sum of each HCEs ADP% ÷ total # of HCEs

NHCEs Avg ADP % = sum of each NHCEs ADP% ÷ total # of NHCEs

1.25 Test

IRC 401(k) AVERAGE DEFERRAL PERCENTAGE TEST

- (1) 1.25 x Average Deferral for Non-Highly Compensated group: 2.50%
 - (2) Lesser of 2% plus AVERAGE DEFERRAL for Non-Highly Compensated group and 2 x AVERAGE DEFERRAL for Non-Highly Compensated group: 4.00%
 - (3) AVERAGE DEFERRAL for Highly Compensated group may not exceed the Greater of (1) and (2): 4.00%
- (This maximum % is based on top-down leveling by percentages. Actual refunds must be based on amounts and hence this maximum % may be exceeded and yet be deemed nondiscriminatory. See IRS Notice 97-2).

Plus 2/Times 2 Test

This % represents which test was used from above. Line (1) (1.25 Test) or Line (2) (Plus 2/Times 2 Test)

THE IRC 401(k) ADP TEST IS NOT SATISFIED. AVAILABLE OPTIONS ARE:

ADP Test results.

Sample ADP Test

Employee Level Detail Page

ABC CORPORATION
ABC CORPORATION 401(k) PLAN

Valuation as of December 31, 2002

IRC 401(k) ADP TEST - EMPLOYEE-LEVEL DETAIL

Plan Compensation amount (Full or Partial (A)) from your census

401(k) Elective Deferral amount from your census

"ADP Numerator" ÷ "Compensation Denominator" or (401(k) Elective Deferral ÷ Plan Compensation)

NAME	COMPENSATION DENOMINATOR	ACTUAL SS#	ADP NUMERATOR	ADP%	H C
ALLEN, SUE	10,000	000-00-0001	0	0.00	N
BYERS, JOSEPH	20,000	000-00-0002	200	1.00	N
DAVIES, CINDY	150,000	000-00-0003	9,000	6.00	Y
HOGAN, MAUREEN	30,000	000-00-0004	1,500	5.00	N

HCE status

Employee Level Detail Sample Page

Sample ADP Test

Refund Page

(Note: This page produced for failed tests only.)

ABC CORPORATION
ABC CORPORATION 401(k) PLAN

Valuation as of December 31, 2002

IRC 401(k) ADP RETURN OF EXCESS CONTRIBUTIONS - EMPLOYEE LEVEL

Prescribed IRS Leveling Method to Determine Refunds

NAME	----- TOP DOWN LEVELING -----			----- ADJUSTED ADP VALUES -----		
	ADP NUMERATOR	ADP NUMERATOR REDUCTION	ADP %	ADP NUMERATOR	ADP NUMERATOR REDUCTION	ADJ ADP NUMERATOR
DAVIES, CINDY	9,000.00	3,000.00	4.00	9,000.00	3,000.00	6,000.00
TOTAL	9,000.00	3,000.00		9,000.00	3,000.00	6,000.00

Adjusted ADP % = "ADP Numerator" - (minus) "Numerator Reduction" ÷ Plan Compensation

401(k) Elective Deferral amount required to be refunded to HCE to satisfy ADP Test (based upon IRS prescribed leveling method)

Adjusted ADP Numerator = "ADP Numerator" - (Minus) "Numerator Reduction"

ADP Refund Sample Page

Sample ACP Test

Test Results Page

Valuation as of December 31, 2002

IRC 401(m) CONTRIBUTION PERCENTAGE TEST

SALARY GROUP	NUMBER OF PARTICIPANTS	CONTRIBUTION* AS % PAY
Highly Compensated	1	3.00%
Non-Highly Compensated	3	1.00%
Total Plan	4	1.50%

HCEs Avg ACP % = sum of each HCEs ACP% ÷ Total # of HCEs

NHCE Avg ACP % = sum of each NHCEs ACP% ÷ Total # of NHCEs

IRC 401(m) CONTRIBUTION PERCENTAGE TEST

- (1) 1.25 x Contribution % for Non-Highly Compensated group:
 - (4) Lesser of 2% plus Contribution % for Non-Highly Compensated group and 2 x Contribution % for Non-Highly Compensated group:
 - (5) Contribution % for Highly Compensated group may not exceed (1) [Alternative Limitation (2) not applied] :
- (This maximum % is based on top-down leveling by percentages. Actual refunds must be based on amounts and hence this maximum % may be exceeded and yet be deemed nondiscriminatory. See IRS Notice 97-2).

1.25 Test

1.25%

2.00%

Plus 2/Times 2 Test

1.25%

This % represents which test was used from above. Line (1) (1.25 Test) or Line (2) (Plus 2/Times 2 Test)

THE IRC 401(m) ACP TEST IS NOT SATISFIED. AVAILABLE OPTIONS ARE:

ACP Test results.

Test Results Sample Page

Sample ACP Test

Employee Level Detail Page

Plan Compensation amount (Full, Partial "A", or Partial "B") from your census

ABC CORPORATION
ABC CORPORATION 401(m) PLAN

Valuation as of December 31, 2002

Employer Match amount from your census

"ACP Numerator" ÷ "Compensation Denominator" or (Employer Match ÷ Plan Compensation)

IRC 401(m) ACP TEST - EMPLOYEE-LEVEL DETAIL

NAME	COMPENSATION DENOMINATOR	ACTUAL SS#	ACP NUMERATOR	ACP%	HCE
ALLEN, SUE	10,000	000-00-0001	0	0	N
BYERS, JOSEPH	20,000	000-00-0002	100	0.50	N
DAVIES, CINDY	150,000	000-00-0003	4,500	3.00	Y
HOGAN, MAUREEN	30,000	000-00-0004	750	2.50	N

HCE Status

Employee Level Detail Sample Page

Sample ACP Test

Refund Page

(Note: This page produced for failed tests only.)

ABC CORPORATION
ABC CORPORATION 401(k) PLAN

Valuation as of December 31, 2002

Prescribed IRS Leveling Method to determine refunds

IRC 401(m) ACP RETURN OF EXCESS CONTRIBUTIONS - EMPLOYEE LEVEL

NAME	----- TOP DOWN LEVELING -----			----- ADJUSTED ACP VALUES -----		
	ACP NUMERATOR	ACP NUMERATOR REDUCTION	ACP %	ACP NUMERATOR	ACP NUMERATOR REDUCTION	ADJ ACP NUMERATOR
DAVIES, CINDY	4,500.00	2,625.00	1.25	4,500.00	2,625.00	1,875.00
TOTAL	4,500.00	2,625.00		4,500.00	2,625.00	1,875.00

Adjusted ACP % = "ACP Numerator" - (minus) "Numerator Reduction" ÷ Plan Compensation

Total Employer Match amount required to be refunded to HCE and/or employer to satisfy ACP Test (based upon IRS prescribed leveling method)

Adjusted ACP Numerator = "ACP Numerator" - (minus) "Numerator Reduction"

Sample 415 Limit Test

Test Results Page

(Note: This test produced only when applicable.)

ABC CORPORATION ABC CORPORATION 401(k) PLAN

Valuation as of December 31, 20021

IRC 415 MAXIMUM ACCOUNT ADDITION ANALYSIS

NAME / SS#		IRC 415 COMPENSATION	---- ACCOUNT ADDITIONS ---- PLAN	MAXIMUM
ALLEN, SUE 000-00-0001	ACTUAL:	10,000.00	0.00	2,500.00
	PROJ:	10,000.00	0.00	2,500.00
BYERS, JOSEPH 000-00-0002	ACTUAL:	20,000.00	300.00	5,000.00
	PROJ:	20,000.00	300.00	5,000.00
DAVIES, CINDY 000-00-0003	ACTUAL:	150,000.00	13,500.00	35,000.00
	PROJ:	150,000.00	13,500.00	35,000.00
HOGAN, MAUREEN 000-00-0004	ACTUAL:	30,000.00	8,000.00	7,500.00
	PROJ:	30,000.00	7,500.00	7,500.00

415 Test Limitation Sample Page

TEST RESULTS REVIEW CHECKLIST

ACTUAL DEFERRAL PERCENTAGE (ADP) TEST

See ADP Test – Employee Level Detail page

- Were all employees eligible to participate¹ for the plan year tested?
 - Under the “Compensation Denominator” column was the correct compensation² used?
 - Was the correct 401(k) elective deferral amount used?
 - Were all Highly Compensated Employees (HCE’s)³ identified with a “Y” in the HCE field?
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ACTUAL CONTRIBUTION PERCENTAGE (ACP) TEST

If you made Employer Matching contributions, see the ACP Test – Employee Level Detail Page

- Were all employees eligible to receive the employer matching contribution included in the ACP test?
 - Was the correct employer match amount used?
 - Did you report \$0.00 for any employee that failed to meet the hour and/or last day requirements to receive a matching contribution?
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415 LIMITATION TEST

See IRC 415 Maximum Account Addition Analysis page

- Was the correct compensation used? ⁴
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- (1) See your plan document (adoption agreement) for plan eligibility requirements.
- (2) See your compensation definition to be used for testing purposes in your plan document.
- (3) See the “Employees” section of the *Census Instructions for Plan Years Beginning in 2001* for the definition of a HCE.
- (4) See the “Compensation” section of the *Census Instructions for Plan Years Beginning in 2001* for the definition of 415 compensation.

IF YOUR PLAN FAILS ADP/ACP TESTING

Acronyms

The following are Internal Revenue Service (IRS) terms referenced in this material.

ADP = Actual Deferral Percentage
ACP = Actual Contribution Percentage
HCE = Highly Compensated Employee
NHCE = Non Highly Compensated Employee
QNEC = Qualified Non-Elective Contribution.
QMAC = Qualified Matching Contribution
EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001
SBJPA = Small Business Job Protection Act of 1996.

What do we do if our plan fails the ADP or ACP test?

The corrective measures to be taken when the ADP or ACP test fails depends on your plan document. Please refer to your plan document to determine your options. You may:

1. be required to refund the Excess Contributions (deferral amounts which cause the ADP test to fail) or the vested portion of the Excess Aggregate Contributions (employer contribution amounts which cause the ACP test to fail) plus any income and minus any loss to the HCEs.
2. be required to make a QNEC (or QMAC) to the NHCEs (and possibly the HCEs).
3. have the option of making a QNEC (or QMAC) to the NHCEs (and possibly the HCEs) in lieu of refunding the Excess Contributions to the HCEs.

Note: If you elected to test your plan based on prior year information, a QNEC (or QMAC) is generally not an option; contact your Plan Services Consultant for additional information.

Note: If the vested portion of the Excess Aggregate Contributions is being returned, any forfeitures of the non-vested portion of the Excess Aggregate Contributions will be refunded to your employer level forfeiture account. The money will be allocated as specified in your plan document.

When do we need to make a QNEC?

QNECs must be made before the end of the plan year following the plan year of the failure. The contribution amounts must be included in your plan's Form 5500. This means you will need to make the contributions within a few weeks of receiving your test results so we can finalize your annual report and include the amounts on your Form 5500 (if AUL has been contracted to complete your 5500). Form 5500 is due 7 months after the end of the plan year.

How are ADP/ACP excess amounts calculated?

The plan must distribute the Excess (or Excess Aggregate) Contribution amount according to the dollar amount deferred by each HCE. The HCE who deferred the largest dollar amount (or received the largest match or made the largest after-tax contribution) will have an Excess (or Excess Aggregate) Contribution amount refunded to the extent either

- required to pass the ADP (or ACP) test; or
 - to the dollar amount deferred by the HCE with the next highest deferral (match or after-tax) amount.
 - This process continues until all of the Excess (or Excess Aggregate) Contribution amount has been returned.
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When must refunds be Processed?

According to the Internal Revenue Code, to avoid disqualification, recovery must be completed by the end of the plan year following the plan year in which the Excess Contributions or Excess Aggregate Contributions occurred.

Is a penalty involved?

If a QNEC (or QMAC) is made, there is no penalty. Otherwise, if distribution of Excess (and/or Excess Aggregate) contributions is not completed within 2 1/2 months after the end of the plan year in which the excess amount occurred, the Plan Sponsor must pay an excise tax (penalty) of 10% of the excess amount and file Form 5330. AUL will prepare a 5330 for you and mail this form with the failed test results.

How are employees' income tax returns affected?

1. If a distribution of the Excess (or Excess Aggregate) Contributions is:
 - a. less than \$100, it is taxable in the year of the distribution.
 - b. made within the 2 1/2-month period after the end of the plan year, the distribution is taxable for the year in which the deferral was originally made (for calendar year plans this date is March 15). If the individual has already filed his or her individual tax return, it will need to be amended.
 - c. made after this 2 1/2 month period (for calendar year plans this date is after March 15), it is taxable in the year of the distribution. The individual will have to report this on the following year's tax return (Year 2003)
 2. All distributions must be reported on Form 1099-R; AUL will prepare these in January, 2004.
 3. The distribution of an Excess Contribution is taxable in its entirety.
 4. The distribution of an Excess Aggregate Contribution derived from a matching contribution is taxable; however, if a distribution of an Excess Aggregate Contribution due to employee after-tax contributions is required, only the income on the Excess Aggregate Contribution is taxable.
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Is there a qualified plan that does not require testing?

Coverage testing (410(b)) remains necessary for all plans. SIMPLE and Safe Harbor plans do not require ADP and ACP testing. Each plan requires:

1. Mandatory Employer Contributions (QMAC, QNEC, or match) that must be 100% vested.
2. SIMPLE 401(k) plans have a lower deferral maximum (\$7,000 versus \$11,000)
3. SIMPLE 401(k) plans are available only to employers with 100 or fewer employees who, in the prior calendar year, had compensation in excess of \$5,000.

There are many issues to consider when deciding to switch from a 401(k) plan to a SIMPLE or Safe Harbor 401(k) plan. Please contact your Regional Sales Office or your Plan Services Consultant for details.