

PEBA

Final 401(k) and 401(m) Regulations Highlights

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Historical Perspective

- Many significant legislative changes have occurred since Section 401(k)/401(m) regulations last finalized in December 1994
- Small Business Job Protection Act of 1996
 - Design based safe harbor alternatives for ADP/ACP testing
 - Prior year NHCE data permitted to be used
 - Modified corrective distribution method for HCEs
 - Permitted ADP/ACP testing ignoring new and younger hires who do not meet permissible age and service exclusions
- Taxpayer Relief Act of 1997
 - Grandfathered state and local government automatically pass ADP/ACP test
 - Matching contributions for self employed no longer deemed elective contributions

Historical Perspective

- Economic Growth and Tax Relief Reconciliation Act of 2001
 - Permitted catch up contributions for age 50 or older participants
 - Roth 401(k) contributions added
 - Same desk rule eliminated
 - Multiple use test eliminated
 - Hardship withdrawal rules less restrictive
 - Safe harbor plans with no additional contributions not top-heavy
 - Faster vesting required for matching contributions
 - Matching contributions taken into account for satisfying top-heavy requirements
- Government responded by issuing numerous Notices and other guidance
 - Notices 97-2, 98-1, and 98-52 (on prior year testing and safe harbor design)
 - Revenue Ruling 2000-8 (automatic enrollment)
 - Revenue Procedure 97-9 (Simple 401(k) plans model amendments)
 - Notices 2001-56 and 2002-4 (EGTRRA changes)

Historical Perspective

- Became cumbersome to locate current IRS thinking on issues
- Proposed regulations published in July 2003 to consolidate and update IRS views on all of these matters
- Final regulations generally adopted proposed regulations with a few minor changes on December 29, 2004

Effective Date

- Final regulations effective for plan years beginning on or after January 1, 2006
- Plan sponsors may rely on them for plan years ending after December 29, 2004
 - Must incorporate all of new rules for entire plan year and all subsequent years
 - To make applicable after year has started (e.g., April 2005) plan will have to have operated in accordance with regulations from beginning of year
- Why would earlier application be desirable?
 - Avoid ESOP testing disaggregation
 - More liberal safe harbor hardship withdrawal rules

Documentation of Testing Methods Used

- Plan document must clearly state testing methods used for ADP/ACP testing
- Prior or current year method if testing
 - Actual NHCE percentage or 3% assumed rate must be stated for first prior year used
- Use of safe harbor method must be indicated
 - Safe harbor alternative to be utilized must also be clear
- Testing methods to be utilized may be incorporated by reference to Code Sections and Regulations
- Any change to testing method now appears to require a plan amendment
- Plan sponsors appear to have a remedial amendment period to make necessary amendments after start of first compliance year

Consistent Testing Method Required

- Same testing method (e.g., prior year, current year or safe harbor) must be used for all CODAs, after tax contributions and matching contributions under a single plan for testing purposes
 - Required after aggregation and disaggregation rules
 - Cannot combine Section 401(k) plans with different testing methods
- One plan can be disaggregated into separate plans with different testing methods
 - Plan with immediate CODA eligibility can use ADP testing for elective deferrals and impose one year eligibility for safe harbor matching contribution
 - Plan document may have to be specific regarding method used for each portion of plan
- Repeated changes of testing procedures that distort ADP/ACP so as to increase significantly the ADP/ACP for HCEs will cause plan to lose 401(k) treatment
 - Preamble states this anti-abuse provision not intended to constrain legitimate testing procedures

Change in Testing Methods

- Proposed and then final regulations dropped the word “subsequent” from the right to switch from prior year to any current year as provided in IRS Notice 98-1
- Appears to now permit switch to current year method after testing year has commenced
 - IRS was at least informally made aware of this change in proposed regulations but did not change final regulations
- Design based safe harbor plan may not change to non-safe harbor plan during plan year
 - Can not amend plan and revert to testing according to preamble

ESOP Disaggregation

- ESOP disaggregation no longer required for 401(k) and 401(m) testing
- Plans with employer stock in ESOP fund to obtain Section 404(k) dividend deduction or in separate ESOP (e.g., leveraged) to provide matching contributions from an ESOP suspense account no longer have to perform two ADP or two ACP tests depending on whether new contributions being invested in ESOP or other plan investments
- Does not eliminate separate Section 410(b) coverage testing or resolve IRS' contribution based Average Benefits Testing position for ESOPs

Targeted QNECs Restricted

- Targeted QNEC to any NHCE in excess of 5% cannot exceed two times the greater of one of two percentages deemed to be the “representative contribution rate”
 - Lowest half NHCE Contribution Rate
 - Last Day Contribution Rate
- Lowest half NHCE Contribution Rate is lowest contribution rate among half of all eligible NHCEs
 - QNECs plus QMACs divided by employee’s compensation
- Last Day Contribution Rate is lowest contribution rate among all NHCE’s employed on last day of plan year
- Targeted QNECs up to 10% if made pursuant to Davis-Bacon Act or similar law prevailing wage requirements
- A plan providing for targeted QNECs will need to be amended to comply with final regulations

GAP Income on Corrective Distributions

- Gap period income (income for the period after the close of the plan year but prior to distribution) must be allocated to HCE corrective distributions
- Two exceptions provided to gap income requirement
 - Gap period does not exceed 7 days for excess contribution distribution
 - HCE would not have incurred gain or loss for the gap period if the HCE's total account were distributed

Hardship Distributions

- Final regulations confirm that the two safe harbor standards are independent
 - Immediate and heavy financial need
 - Distribution necessary to satisfy the need
- Confirm EGTRRA's reduced six month suspension for safe harbor hardship distribution
 - Required for safe harbor design
- Two new safe harbor events provided
 - Funeral expenses for parents, spouse, children or dependents
 - Repairs to principal residence for damage that qualifies as casualty loss
- Medical expenses must be deductible (without regard to 7.5% of adjusted gross income required) to constitute a hardship
 - Dependent for medical expense includes a non-custodial child
 - Non prescription drugs or medicine, except insulin, excluded
- Plan sponsor can ignore Working Families Tax Relief Act of 2004 change in definition of dependent, even before final regulations effective, and recognize dependent hardship for post-secondary education and medical

Other Distributions

- Separation from service requirement transformed into EGTRRA's severance from employment
- Retirement included in severance from employment
- Changing from a common law employee into a leased employee not deemed to constitute severance from employment according to preamble
- Non profit employers who terminate Section 401(k) plan and distribute accounts can maintain Section 403(b) and Section 457(b) and (f) plans without jeopardizing Section 401(k) plan status

Prefunding of Contributions

- Cash prefunding of elective and matching contributions generally prohibited
- Contribution must be made only after timely election and related employment services performed by employee
- Final regulations provide three limited exceptions to the prefunding prohibition
 - Matching contributions from ESOP suspense account generated by required ESOP loan repayment
 - Matching contributions provided by allocating forfeitures
 - Occasional contributions for a payroll period before services performed due to bona fide administrative reasons

Catch Up Contributions

- Catch up contributions generally not counted for ADP testing
- Additional or catch up deferrals after military service are not counted for ADP testing
- Catch up contributions not in excess of plan's matched contribution percentage must receive safe harbor matching contributions

Roth 401(k) Contributions

- Final regulations clarify that Roth 401(k) after tax contributions not excluded from definition of CODA
 - Treated as elective contributions included in ADP testing
- Right to make Roth 401(k) contribution is a benefit right or feature
 - Eligibility group must be nondiscriminatory
- Further proposed regulations released March 1, 2005 pursuant to reserved section of final 401(k) regulations
 - Employee must make irrevocable designation of Roth at time of CODA election
 - Separate account must be maintained for Roth contributions, earnings and withdrawals
 - Forfeitures may not be allocated to Roth accounts
 - HCEs can designate whether excess contributions are pre-tax or Roth if corrective distribution required
 - Roth contributions subject to minimum distribution rules
 - Can be rolled over only to another plan maintaining Roth 401(k) or to a Roth IRA