

IRS Issues Final 401(k) and 401(m) Regulations

WHO'S AFFECTED These rules affect 401(k) plans. They also affect other types of defined contribution plans, including 403(b) plans, that accept employee post-tax contributions or employer matching contributions. In addition, they apply to defined benefit plans that accept voluntary employee post-tax contributions.

BACKGROUND AND SUMMARY On December 29, 2004, the IRS published final 401(k) and 401(m) regulations. For the most part, these regulations simply consolidate numerous pieces of official guidance that the IRS has issued since final 401(k) and 401(m) regulations were last published, in 1991. However, these regulations also contain some new rules, which will require both plan amendments and changes to administrative procedures. This publication discusses some of the more notable changes and clarifications provided by these regulations.

ACTION AND NEXT STEPS These final regulations apply to plan years beginning on and after January 1, 2006. Plan sponsors may choose to apply the new rules to any plan year ending after December 29, 2004. However, if *any* of the new rules is applied before the 2006 plan year, *all* of the new rules must be applied. As a result, plan sponsors that see a benefit in applying any new rule before 2006, must be careful to analyze the effect of applying all other new rules at the same time.

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Basic Plan Design

Automatic Enrollment

In prior guidance, the IRS had illustrated the automatic enrollment concept with examples that referred to automatic deferral percentages of 3% of compensation. These final regulations clarify that lower and higher default percentages are acceptable.

Ongoing Deferral Elections

The final rules clarify that a plan must provide an “effective opportunity” for employees to make or change deferral elections at least once each plan year.

Contribution Pre-Funding

In general, the final regulations provide that a contribution is considered to be a deferral contribution only if it is made after the employee has performed the services relating to the compensation from which the deferral is made. A similar rule applies to employer matching contributions. These new rules are designed to prevent employers from pre-funding contributions in order to accelerate tax deductions and actually reverse the position the IRS took in Notice 2002-48.

An exception to these rules is provided to accommodate a bona fide administrative situation (for an occasional pay period only) that is not for the principal purpose of accelerating deductions. For example, the regulations mention the temporary absence of the employer’s bookkeeper who is responsible for transmitting contributions to the plan.

In addition, this rule is not intended to prevent partners from deferring amounts throughout the year from their draws, provided contribution limits are not exceeded.

Nondiscrimination Rules

Plan Aggregation and Disaggregation Rules

As expected, the final rules provide that the Employee Stock Ownership Plan (ESOP) and Non-ESOP portions of a plan do not have to be disaggregated for actual deferral percentage (ADP) and actual contribution percentage (ACP) testing, but must still be disaggregated for coverage testing.

The rules also require that a single ADP/ACP testing method be applied to each “plan” (determined under the aggregation and disaggregation rules). As a result, an employer cannot aggregate a plan that uses ADP testing with an ADP Safe Harbor plan when performing minimum coverage testing.

Nondiscrimination in Amounts

The final regulations clarify that the ADP Test, ADP Safe Harbor design and SIMPLE 401(k) design are three different ways for the 401(k) portion of a plan to satisfy the nondiscrimination in amounts requirement. Therefore, an employer cannot adopt an ADP Safe Harbor design and include a fall-back onto the ADP Test if the plan fails to meet all of the Safe Harbor requirements (e.g., providing Participant notices to all participants during the appropriate timeframe).

Likewise, the ACP Test, ACP Safe Harbor design and SIMPLE 401(k) design are three different ways for the 401(m) portion of a plan to satisfy the nondiscrimination in amounts requirement. Again, an employer cannot adopt an ACP Safe Harbor design and include a fall-back onto the ACP Test if the plan fails to meet all of the Safe Harbor requirements.

Since it is not unusual for plan sponsors to accidentally miss the timing requirement for providing Safe Harbor Notices, or miss some employees when distributing these Notices, this new provision is somewhat disturbing. Hopefully, the next update to the IRS Employee Plans Compliance Resolution System (EPCRS) corrective program will include mechanisms for correcting accidental failures to satisfy all ADP/ACP Safe Harbor requirements.

ADP and ACP Testing

The final rules confirm that two special ADP and ACP testing options are available to plans that allow employees to participate before they reach age 21 or complete one year of service. These plans may use either the Small Business Jobs Protection Act (SBJPA) early participation rule or the original “otherwise excludible” disaggregation rule.

In addition, these rules confirm that a plan generally may use different methods (prior year, current year) for its ADP and ACP Tests. However, if different testing methods are used, the plan cannot “borrow” deferrals for ACP testing or “borrow” qualified matching contributions (QMACs) for ADP testing. In addition, elective deferrals cannot be included in an ACP Test if the Plan is not subject to the ADP Test (e.g., ADP Safe Harbor Plans and 403(b) programs).

The final regulations also modify the manner in which the actual deferral ratio (ADR) is determined for a highly compensated employee (HCE) who participates in more than one 401(k) arrangement. In this situation, the ADR is determined by aggregating the HCE’s elective deferrals made within the plan year of the plan being tested. A similar rule applies for determining the actual contribution ratio (ACR) of an HCE participating in more than one 401(m) plan.

Correction of ADP and ACP Test Failures

The final rules now require gap period income to be included in corrective distributions of excess contributions and excess aggregate contributions. However, income for the seven days preceding the actual payment date does not have to be included. If corrective distributions cannot be made within seven days of the calculation date, plans may have to use the 10% safe harbor method of calculating gap period income, since that method provides a 15-day payment window.

These rules also provide that if an HCE participates in more than one 401(k) plan, all of his deferrals are aggregated (as noted above) for purposes of ranking HCEs by the dollar amount of

their contributions. However, only elective deferrals made to the plan being corrected may be distributed. A similar rule applies to ACP Test corrections.

As expected, the final regulations impose new limitations on correcting failed ADP or ACP Tests by making targeted (bottom-up) qualified non-elective contributions (QNECs) or QMACs:

- A targeted QNEC cannot exceed the greater of
 - (a) 5% of an NHCE's compensation (10% if the QNEC is made in accordance with prevailing wage rules, such as the Davis-Bacon Act), or
 - (b) 2 times the plan's "representative contribution rate."

- A targeted QMAC cannot exceed the greatest of
 - (a) 5% of an NHCE's compensation (10% if the QMAC is made in accordance with prevailing wage rules),
 - (b) 100% of elective deferrals, or
 - (c) 2 times the plan's "representative matching rate" multiplied by the employee's elective deferrals for the year.

ADP and ACP Safe Harbor Plans

ADP and ACP Safe Harbor contributions must be made to all eligible employees. These regulations confirm that plans cannot require employees to be employed on the last day of the plan year or to complete 1000 hours of service during the plan year in order to receive a Safe Harbor contribution.

In general, a Safe Harbor Plan must be adopted before the beginning of the plan year and must be maintained throughout a full 12-month plan year. However, the final rules provide the following exceptions to the 12-month plan year requirement:

- The year of plan termination if that termination is in connection with a merger or acquisition involving the employer and the employer makes the safe harbor contribution through the date of plan termination;
- The year of plan termination if that termination is due to the employer incurring a substantial business hardship and the employer makes the safe harbor contribution through the date of plan termination;
- The year of plan termination, regardless of the reason for termination, *if* the employer makes the safe harbor contribution for the short plan year, employees are notified of the change, *and* the plan passes the ADP Test.
- A short plan year that is sandwiched between two full 12-month-long safe harbor plan years (unless the following plan year is a short plan year due to plan termination).

Nondiscriminatory Availability

The final regulations clarify that both the availability of each level of deferral contributions and the right to make designated Roth contributions are "rights or features" that are subject to availability testing.

Distributions

In General

Under these final rules, 401(k) deferral contributions may be distributed on account of:

- Death,
- Disability,
- Severance from employment,
- Age 59½,
- Hardship, or
- Plan termination.

Since “severance from employment” has replaced “separation from service” as a distributable event, there is no longer a need to permit distributions due to a “sale of assets or sale of subsidiary.”

Safe Harbor Hardship Withdrawals

The final 401(k) regulations continue to provide safe harbor rules for determining if an employee has an immediate and heavy financial need (a “needs” safe harbor) and whether a distribution is necessary to satisfy an immediate and heavy financial need (an “amounts” safe harbor). In addition to the four safe harbor “needs” already established, the rules also include the following situations:

- Funeral/burial expenses for parent, spouse, child, dependent; and
- Repair of damage to employee’s principal residence that qualified for casualty deduction.

In addition, these rules clarify that the Working Families Tax Relief Act of 2004 (WFTRA) change in the definition of dependent does not apply to 401(k) rules permitting hardship withdrawals due to a dependent’s medical, educational or funeral costs. Plan sponsors may ignore the WFTRA changes in 2005, despite existing plan document provisions that may incorporate them by reference, without having to amend plans to apply the new rules before 2006.

The revised rules also provide that for purposes of the “amounts” safe harbor:

- ESOP dividend distributions are included in the loans and distributions that must be taken before a participant may take a hardship withdrawal;
- A participant must request all other available plan distributions and loans, even if they would not be enough to satisfy the need; however, a commercial loan does not have to be requested if it would not be enough to satisfy the need.

Distributions at Plan Termination

The final regulations continue to permit 401(k) plans to distribute deferral contributions at plan termination, but only if the employer does not maintain or establish an alternative defined contribution plan. Alternative plans do not include SIMPLE IRAs, 403(b) programs, or section 457 plans, in addition to ESOPs and Simplified Employee Pension (SEP) plans.

Miscellaneous

Elective deferrals are always 100% vested, and these final regulations confirm that deferrals must be taken into account when a plan applies the “rule of parity” for vesting purposes. Under the rule of parity, a nonvested rehired employee may permanently lose all of his prior vesting service. However, a partially-vested participant cannot lose service credit under this rule. A participant, who is 0% vested in employer contributions but has made deferral contributions, cannot be treated as a nonvested participant for purposes of applying the rule of parity.

In addition, these new rules require that deferral contributions be taken into account when determining whether a terminated employee’s account can be “deemed distributed.” Many plans contain a deemed distribution provision, which provides that when a participant who is 0% vested in employer contributions terminates employment, he will be considered to have taken a distribution of his total account balance. As a result, his nonvested account balance can be immediately forfeited to the plan. Under the final regulations, the nonvested account balance of an employee who has made deferral contributions and is 0% vested in employer contributions can only be forfeited immediately at termination of employment if the employee’s deferral contributions are actually distributed at that time.

Impact of These Regulations

These new and revised rules will have an impact on both plan documents and plan operation.

Plan Documents

Virtually all 401(k) plans will have to be amended to reflect these new regulations. However, the IRS has not indicated whether plans must be amended before the rules can be put into operation (i.e., by the end of the 2005 plan year). In addition, the IRS has not indicated whether it will provide model or sample plan amendments.

Plan Operation

As a result of these new regulations, a number of plan administrative procedures may need to be revised. For example:

- Plans that wish to reflect the new safe harbor hardship withdrawal rules will have to revise their hardship withdrawal paperwork and procedures to reflect the new hardship circumstances.
- ADP and ACP Test corrective distribution procedures will have to be revised to reflect the new requirement to pay gap period income.

Next Steps

Prudential Retirement is currently reviewing these rules and their impact on both the plan documents that we provide and our administrative procedures. In conjunction with the recent opening of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) determination letter program, we will be restating our prototype and volume submitter plan documents to reflect these new rules. If interim plan amendments, reflecting these final regulations, are needed, we will contact clients to make the appropriate arrangements. In addition, we will contact you as we make

changes to our administrative procedures to comply with these new rules. If you have questions about how these regulations affect your plan, please contact your Prudential Retirement representative.

Pension Analyst by Prudential Retirement

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