The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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IRS ISSUES FINAL REGULATIONS ON 401(K) PLANS

[18375] December 31, 2004 TO: PENSION MEMBERS No. 66-04 PENSION OPERATIONS ADVISORY COMMITTEE No. 87-04 RE: IRS ISSUES FINAL REGULATIONS ON 401(K) PLANS The Internal Revenue Service has issued final regulations setting forth the requirements for cash or deferred arrangements ("CODAs") under section 401(k) 1and matching or employee contributions under section 401(m) ("Final Regulations").2 These Final Regulations are generally intended to restate and consolidate prior guidance on 401(k) plans, as well as reflect the legislative changes that have been enacted since the previous final regulations were last amended in December 1994 (the "1994 regulations"). The Final Regulations address numerous topics under sections 401(k) and 401(m), such as: (1) the general structural requirements CODAs; (2) the nondiscrimination requirements for 401(k) plans, including the actual deferral percentage ("ADP") test and related correction methods; (3) matching and employee contribution requirements, including the actual contribution percentage ("ACP") test and related correction methods; (4) the aggregation and disaggregation of 401(k) plans for nondiscrimination testing purposes; (5) applicable withdrawal restrictions; (6) prior year testing requirements; (7) safe harbor 401(k) and (m) rules; and (8) the requirements for SIMPLE 401(k) plans. The Final Regulations reflect a number of substantive changes and clarifications to previously issued guidance and include suggestions made by the Institute on the regulations proposed in 2003.3 CODAs Under Section 401(k). The Final Regulations generally follow the proposed regulations'4 treatment of CODAs, with some modifications. As under prior guidance, CODAs would not include one-time irrevocable elections and contributions that are treated as after-tax employee contributions at the time of contribution. However, an arrangement under which 1 Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended. 2 The Final Regulations are available on Treasury's website at http://www.treasury.gov/press/releases/reports/401k122804td9169.pdf. 3 See Institute Memorandum (No. 16699) to Pension Members No. 46-03 and Pension Operations Advisory Committee No. 71-03, dated October 24, 2003. 4 See Institute Memorandum (No. 16324) to Pension Members No. 34-03 and Pension Operations Advisory Committee No. 44-03, dated July 18, 2003. 2 employees make designated after-tax Roth contributions will be treated as a CODA. Roth 401(k) contributions will be addressed in separate guidance, according to the preamble to the Final Regulations. Like the proposed regulations, the Final Regulations clarify that contributions in anticipation of future performance of services generally would not be treated as elective contributions under section 401(k); thus, an employer would not be able to prefund elective contributions to accelerate the deduction for elective contributions. However, the Final Regulations contain an exception to this rule for occasional bona fide administrative considerations. Employer contributions will not fail to satisfy the regulatory requirements relating to the timing of elective contributions merely

because contributions for an occasional pay period are made before the services with respect to that pay period are performed, provided that the early contributions are made for bona fide administrative considerations and are not made with the principal purpose of accelerating deductions. Automatic Enrollment. The Final Regulations incorporate prior IRS guidance permitting automatic plan enrollment under a CODA.5 The regulations do not prohibit an employer from contributing increases in compensation or bonuses on an employee's behalf to a trust, provided that the employee has an effective opportunity to elect to receive that amount in cash.6 Gap Period Income. The Final Regulations provide that income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year and, to the extent the excess contributions are or will be credited with allocable gain or loss for the period after the close of the plan year (gap period), the allocable gain or loss for the gap period.7 The Final Regulations permit the use of either a safe harbor method or an alternative method for computing gap period income. The safe harbor method raises issues for plan administrators, and the alternative method is not administratively feasible for plans that invest in mutual funds. As requested by the Institute, the Final Regulations provide administrative relief for plans that invest in mutual funds, which use daily valuations. Specifically, the Final Regulations provide that a distribution of excess contributions is not required to include income allocable to the excess contributions for a period of not more than 7 days before the distribution. Tax Treatment of Corrective Distributions. As requested by the Institute, the Final Regulations correct a discrepancy between the language of the 1994 regulations and the proposed regulations relating to the tax treatment of corrective distributions. Treas. Reg. 1.401(k)-1(f)(4)(v) provides that, except as otherwise provided, a corrective distribution of excess contributions (and income) that is made within 2 ½ months after the end of the plan year 5 See Institute Memorandum (No. 11594) to Pension Members No. 9-00 and Pension Operations Advisory Committee No. 7-00 (11594), dated February 1, 2000 (Revenue Ruling 2000-8). The Final Regulations, however, note that the Department of Labor has taken the position that a participant will not be considered to have exercised control when the participant is merely apprised of investments that will be made on his or her behalf in the absence of instructions to the contrary. 6 The Institute requested that the Final Regulations expressly approve these arrangements. Although the Final Regulations are silent on this point, express guidance sought by the Institute was issued in an information letter. See Institute Memorandum (No. 17370) to Pension Members No. 25-04 and Pension Operations Advisory Committee No. 31-04, dated April 13, 2004. 7 Reg. 1.401(k)-2(b)(2)(iv)(A). 3 for which the excess contributions were made is includable in the employee's gross income on the earliest dates any elective contributions by the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash. Prop. Treas. Reg. 1.401(k)-2(b)(2)(vi)(A), which was the corresponding provision of the proposed regulations, included the same language above, except that the word "dates" was changed to "date." This change, if intended, would have changed the manner in which some corrective distributions are taxed. The language in the Final Regulations corresponds to the 1994 language and uses the word "dates." Aggregation and Disaggregation with Employee Stock Ownership Plans ("ESOPs". The Final Regulations retain the proposed regulations' rule that eliminates the mandatory disaggregation of the ESOP and non-ESOP portions of a plan (under section 414(l)) for purposes of ADP and ACP testing. For purposes of applying the ADP or ACP tests, an employer may permissively aggregate two section 414(l) plans, one that is an ESOP and one that is not. The exception to the mandatory disaggregation of ESOPs and non-ESOPs, however, does not apply for purposes of section 410(b) (i.e., minimum coverage requirements). Thus, a group of eligible employees under both the ESOP and non-ESOP portions of a plan must still separately satisfy the requirements of sections 401(a)(4) and 410(b). ADP Test. The Final Regulations

generally follow the proposed regulations with respect to ADP testing rules. For example, the Final Regulations provide that catch-up contributions that are in excess of a statutory limit or an employer-provided limit are not taken into account under the ADP test. The Final Regulations add a comparable rule for additional elective contributions that are made by reason of an eligible employee's qualified military service pursuant to section 414(u). The Final Regulations reflect the catch-up contribution rules under section 414(v).8 The Final Regulations permit plans to incorporate the ADP and ACP tests by reference. However, the plan must specify any optional provisions, such as the use of current versus prior year testing. The Institute requested that the Final Regulations expressly state the historically-understood rule that it is permissible to change the testing method by amending the plan through the end of the 2 ½ month period immediately following the close of the plan year. Although the Final Regulations do not expressly incorporate this provision, the preamble states that the Commissioner may provide additional, separate guidance regarding these rules. Targeted QNECs Under ADP Test. The Final Regulations retain a new requirement from the proposed regulations that restricts the use of the "bottom-up leveling" correction approach to satisfy the ADP test. The preamble explains that under such a method, an employer could pass the ADP test by contributing small amounts of qualified nonelective contributions ("QNECs") to non-highly compensated employees ("NHCEs") with low compensation for the plan year. The Final Regulations provide that a QNEC for an NHCE that exceeds 5 percent of compensation may be taken into account for the ADP test only to the extent the contribution, when expressed as a percentage of compensation, does not exceed two times the plan's 8 See Institute Memorandum (No. 16290) to Pension Members No. 32-03 and Pension Operations Advisory Committee No. 41-03, dated July 11, 2003. 4 representative contribution rate (i.e., the lowest contribution rate among a group of NHCEs that is half of all the eligible NHCEs under the arrangement (or the lowest contribution rate among all eligible NHCEs under the arrangement who are employed on the last day of the year, if greater)). In determining a NHCE's contribution rate, an employee's QNECs and qualified matching contributions ("QMACs") taken into account under the ADP test for the plan year are added together and the sum is divided by the employee's compensation for the same period. The Final Regulations prohibit the double counting of QNECs in a manner generally consistent with Notice 98-1.9 The Final Regulations provide greater flexibility for QNECs that are made in connection with an employer's obligation to pay a prevailing wage under the Davis-Bacon Act, Service Contract Act of 1965 or similar legislation by allowing a QNEC of up to 10 percent of compensation to be taken into account under the ADP test in such a case. Distribution Restrictions and Hardship Distributions. The Final Regulations incorporate statutory changes to certain distribution rules (e.g., eliminating the "same desk rule" and reducing from 12 to 6 months the period for which an employee is prohibited from making contributions following a hardship distribution) made by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). The Final Regulations clarify the application of the safe harbor standards for hardship distributions by requiring that an employee's "hardship" representation state that the need cannot be reasonably relieved by any available distribution or nontaxable plan loan.10 The Final Regulations clarify the application of the existing safe harbors to the hardship standards. Additionally, the Final Regulations treat funeral expenses and certain expenses related to the repair of damage to the employee's principal residence as additional events that are eligible for hardship distributions. Finally, the Final Regulations add provisions that allow medical expenses and post-secondary educational expenses for an employee, spouse, or dependent (without regard to the 2004 Working Families Tax Relief Act's modified definition) to be eligible for hardship distributions. Section 401(m) Matching Contributions and Employee Contributions. Consistent with the current regulatory structure, the Final Regulations include separate, parallel regulations under section 401(m). The Final Regulations generally follow the

proposed regulations regarding section 401(m) matching contributions and employee contributions. Targeted QNECs and QMACs Under Section 401(m). The Final Regulations allow QNECs to be taken into account for ACP testing, but the same restrictions under the section 401(k) Final Regulations on targeting QNECs to a small number of NHCEs apply. The Final Regulations generally follow the proposed regulations. For example, the Final Regulations retain rules from the proposed regulations that limit targeted matching contributions for NHCEs from being taken into account in the ACP test to the extent the matching rate for the contribution exceeds the greatest of (1) 5% of compensation, (2) the employee's elective deferrals for the year, and (3) the product of 2 times the representative matching rate and the 9 See Institute Memorandum (No. 9623) to Pension Members No. 5-98, dated January 27, 1998. 10 An employee's representation, however, need not provide that a loan from a commercial source will be taken if no such loan in an amount sufficient to satisfy the need is available on reasonable commercial terms. 5 employee's elective deferrals for the year. In determining the representative matching rate, the Final Regulations add a new rule if the matching rate is not the same for all levels of elective contributions for an employee. In such a case, the employee's matching rate is determined assuming that an employee's elective deferrals are equal to 6 percent of compensation. There is also a parallel rule for matching employer contributions. Safe Harbor 401(k) and (m) Requirements. The Final Regulations generally follow the proposed regulations' rules regarding safe harbor 401(k) and 401(m) requirements. However, they do not provide exceptions for circumstances under which elective contributions by NHCEs to a safe harbor plan could be less than the amount required to be matched, or the extent to which a safe harbor plan could be required to match catch-up contributions under such circumstances. Such rules were contemplated in the proposed regulations. Electronic Submissions. The Institute comments on the proposed regulations expressed strong support for the use of electronic notices and other types of communications with plan participants. The Final Regulations provide that the requirement in section 401(k)(12)(D) that each eligible employee be provided with written notice of the employee's rights and obligations under the plan can be provided in writing or through another medium that is prescribed by the Commissioner as satisfying the requirement for a written notice. The preamble to the Final Regulations states that the IRS and Treasury are currently developing guidance setting forth the extent to which the notice described in section 401(k)(12)(D), as well as other notices under various requirements relating to qualified plans, can be provided electronically, taking into account the effect of the Electronic Signatures in Global and National Commerce Act ("E-SIGN").11 Until this guidance is issued, plan administrators and employers may continue to rely on the interim guidance provided in Notice 2000-3 on the use of electronic media.12 Effective Date. The Final Regulations apply for plan years beginning on or after January 1, 2006. However, plan sponsors are permitted to apply these Final Regulations to any plan year that ends after December 29, 2004, provided that the plan applies all the rules of the Final Regulations, to the extent applicable, for that plan year and all subsequent plan years. Lisa Robinson Associate Counsel 11 See Institute Memorandum (No. 12402) to Pension Members No. 39-00, Pension Operations Advisory Committee No. 56-00, Electronic Commerce Advisory Committee No. 5-00, SEC Rules Members No. 54-00 and Tax Members No. 22-00, dated July 28, 2000. 12 See Institute Memorandum (No. 11530) to Pension Members No. 3-00 and Pension Operations Advisory Committee No. 2-00, dated January 7, 2000.