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IRS ISSUES COMPREHENSIVE PROPOSED REGULATIONS ON 401(K) PLANS

[16324] July 18, 2003 TO: PENSION MEMBERS No. 34-03 PENSION OPERATIONS ADVISORY COMMITTEE No. 44-03 RE: IRS ISSUES COMPREHENSIVE PROPOSED REGULATIONS ON 401(k) PLANS The Internal Revenue Service has issued proposed regulations setting forth the requirements for cash or deferred arrangements under Code section 401(k) and matching or employee contributions under section 401(m).1 These proposed 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 existing final regulations were last amended in December 1994. Treasury and the IRS are seeking comments on the proposed regulations, particularly with regard to their impact on plan systems and practices.2 Written comments on the proposed regulations must be submitted to the IRS by October 22, 2003. A public hearing also has been scheduled for November 12, 2003.3 The proposed regulations are comprehensive in scope and address numerous topics under Code sections 401(k) and 401(m), such as: (1) the general structural requirements of cash or deferred arrangements (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 preamble to the proposed regulations provides that Treasury and the IRS — in reviewing and integrating the existing administrative guidance under sections 401(k) and 401(m) — have reconsidered certain rules and, consequently, proposed certain changes. The 1 The proposed regulations as published in the Federal Register on July 17 is available at: http://a257.g.akamaitech.net/7/257/2422/14mar20010800/edocket.access.gpo.gov/2003/pdf/03-17755.pdf. The proposed regulations also may be found on Treasury's website at: http://www.treasury.gov/press/releases/reports/401(k)(m)fullreg.doc. 2 Other specific topics for which Treasury and the IRS are interested in receiving comments are discussed below. 3 Requests to speak at the hearing must be submitted by the comment deadline. 2 proposed regulations, therefore, reflect a number of substantive changes and clarifications to previously issued guidance. Such modifications and other notable aspects of the proposed regulations highlighted in the preamble include the following. CODAs Under Section 401(k). As under the existing regulations, the proposed regulations generally define a CODA as an arrangement under which employees can make a cash or deferred election with respect to contributions to, or accruals or benefits under, a plan intended to satisfy the requirements of section 401(a).4 Under the proposed regulations, however, CODAs would not include an arrangement under which dividends paid to an employee stock ownership plan (ESOP) are

either distributed to a participant or reinvested in employer securities in the ESOP under a participant's election under section 404(k)(2)(A)(iii), as added by EGTRRA. The proposed regulations also 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. Additionally, the proposed regulations incorporate prior IRS guidance permitting automatic plan enrollment under a CODA.5 Aggregation and Disaggregation with ESOPs. The proposed regulations would change the treatment of a CODA under a plan that includes an ESOP.6 Specifically, the proposed regulations would eliminate the mandatory disaggregation rule with regard to the ESOP and non-ESOP portions of a plan (under Code section 414(l)) for purposes of ADP testing. The same approach would apply for ACP testing under section 401(m). 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, would 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). The proposed regulations also would provide that a single testing method must apply to all CODAs under a plan. Accordingly, an employer would be restricted from aggregating section 414(l) plans for purposes of section 410(b), if those plans apply inconsistent testing methods.7 4 As under prior guidance, CODAs would not include contributions that are treated as after-tax employee contributions at the time of contribution and one-time irrevocable elections. 5 See Institute Memorandum to Pension Members No. 9-00 and Pension Operations Advisory Committee No. 7-00 (11594), dated February 1, 2000 (Revenue Ruling 2000-8). The proposed regulations, however, provide 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 preamble notes that the use of an ESOP as an employer stock fund in a 401(k) plan has become more widespread since the issuance of the existing regulations. 7 For example, for purposes of section 410(b), a plan that uses the ADP safe harbor under section 401(k)(12) may not be aggregated with a plan that applies a non-safe harbor ADP test. 3 ADP Test. The proposed regulations, which generally retain the structure for ADP testing under the existing regulations, incorporate the rule in Treas. Reg. 1.402(g)-1 providing that excess deferrals that are distributed are still taken into account under the ADP test, with the exception of deferrals made by NHCEs that were in violation of section 401(a)(30). The proposed regulations also reflect the recently-finalized catch-up contribution regulations under section 414(v).8 In the context of catch-up contributions under safe harbor 401(k) plans, Treasury and the IRS request comments on the circumstances under which elective contributions by non-highly compensated employees (NHCEs) would be less than the amount required to be matched, and the extent to which a safe harbor plan should be required to match catch-up contributions under such circumstances. Targeted QNECs Under ADP Test. The proposed regulations add a new requirement 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 can pass the ADP test by contributing small amounts of qualified nonelective contributions (QNECs) to NHCEs with low compensation for the plan year. Specifically, the proposed regulations would provide that a QNEC that exceeds 5 percent of compensation may be taken into account for an ADP test only to the extent the contribution, when expressed as a percentage of compensation, does not exceed two times the plan's 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.9 Finally, the proposed regulations would prohibit the double counting of QNECs in a manner generally consistent with Notice 98-1.10 Distribution Restrictions. In addition to incorporating EGTRRA's statutory changes to certain distribution rules (e.g., the elimination of the "same desk rule," and the reduction from 12 to 6 months the period for which an employee is prohibited from making contributions following a hardship distribution), the proposed regulations would clarify the application of the safe harbor standards for hardship distributions by requiring an employee's "hardship" representation to provide that the need cannot be reasonably relieved by any available distribution or nontaxable plan loan.11 The proposed regulations also clarify the application of the existing safe harbors to the hardship standards. 8 See Institute Memorandum to Pension Members No. 32-03 and Pension Operations Advisory Committee No. 41-03 (16290), dated July 11, 2003. 9 As discussed below, the proposed regulations under section 401(m) would provide parallel restrictions on QNECs taken into account in ACP testing. 10 See Institute Memorandum to Pension Members No. 5-98 (9623), dated January 27, 1998. 11 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. 4 The proposed regulations would modify the existing regulations on the types of plans that an employer may maintain after the termination of a CODA, as well as clarify the effect on withdrawal restrictions for elective deferrals, QNECs and QMACs where a plan-to-plan transfer takes place. Section 401(m) Matching Contributions and Employee Contributions. Consistent with the current regulatory structure, the proposed regulations include separate, parallel regulations under Code section 401(m). As under the existing regulations, whether an employer contribution is on account of an elective deferral or employee contribution — and therefore a matching contribution — is determined based on all relevant facts and circumstances. Furthermore, the section 401(m) rules, similar to those under section 401(k), prohibit employers from prefunding matching contributions to accelerate the deduction for those contributions. Accordingly, where a contribution is made before an employee's elective deferral or his or her performance of services with respect to which an elective deferral is made, the employer contribution would not be treated as a matching contribution. The proposed regulations on ACP testing under section 401(m) are generally parallel to the rules for ADP testing. This includes the determination of the actual contribution ratio (ACR) for employees and the contributions taken into account in determining the ACR. The proposed regulations under section 401(m) also provide rules on plan aggregation and disaggregation similar to those under section 401(k). For instance, matching contributions made under the portion of the plan that is an ESOP and the portion of the same plan that is not an ESOP would not be subject to mandatory disaggregation under the proposed regulations. Targeted QNECs and QMACs Under Section 401(m). The proposed regulations would continue to allow QNECs to be taken into account for ACP testing, but the same restrictions under the section 401(k) proposed regulations on targeting QNECs to a small number of NHCEs would apply. The difference between the 401(m) versus the 401(k) rules would be that the contribution percentages used to determine the lowest contribution percentage would be based on the sum of the QNECs and those matching contributions taken into account in the ACP test, rather than the sum of the QNECs and the QMACs taken into account under the ADP test. Because QNECs that do not exceed 5 percent are not subject to the limits on targeted QNECs under either the ADP or ACP tests, an employer may take into account up to 10 percent in QNECs for an eligible

NHCE — 5 percent in ADP testing and 5 percent in ACP testing — without regard to how many NHCEs receive QNECs. To prevent an employer from using targeted matching contributions to circumvent the limitation on targeted QNECs, the proposed regulations would provide that matching contributions are not considered in ACP testing to the extent the matching rate for the contribution exceeds the greater of 100 percent and 2 times the representative matching rate (i.e., the lowest matching rate for any eligible employee in a group of NHCEs that consists of half of all eligible NHCEs in the plan for the plan year (or the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year, if greater)). For this purpose, the matching rate is the ratio of the matching contributions to the contributions being matched, and only NHCEs who make elective deferrals or employee contributions for the plan year would be considered. 5 The proposed regulations also set forth a new rule providing that elective contributions under a plan that is not subject to the ADP test (e.g., a plan that uses the safe harbor method of section 401(k)(12) or a contract or arrangement under section 403(b)(12)(A)(ii)) may not be taken into account for the ACP test. Section 401(m) rules on the correction of excess contributions and calculation of allocable income would be generally consistent with the 401(k) proposed regulations. Existing rules on correction through distribution of vested matching contributions and forfeiture of unvested matching contributions would continue to apply. Safe Harbor 401(k) and (m) Requirements. While the proposed regulations generally follow the safe harbor rules set forth in Notice 98-52 and Notice 2000-3,12 they provide a number of clarifications and modifications to the existing rules. For example, the proposed regulations clarify that under a safe harbor 401(k) plan, elective or matching contributions on behalf of a highly compensated employee (HCE) who is eligible to participate in more than one plan of the same employer need not be aggregated for purposes of the ADP safe harbor.13 With regard to section 401(m) requirements, the proposed regulations would clarify that for purposes of determining whether an HCE has a higher rate of matching contributions than any NHCE, any NHCE who is an eligible employee under the safe harbor plan must be taken into account, even if the NHCE is not eligible for a matching contribution. As a result, a plan that limits matching contributions to employees who are employed on the last day of the plan year will not be able to satisfy the ACP safe harbor, given that a NHCE who is not eligible to receive a matching contribution because of this requirement will nonetheless be considered under the safe harbor 401(m) requirements. The proposed regulations also would require that matching contributions made at the employer’s discretion for any employee not exceed a dollar amount equal to 4 percent of the employee’s compensation and that a safe harbor plan must permit all eligible NHCEs to make sufficient elective contributions to receive the maximum matching contribution offered under the plan. In addition, the preamble highlights the fact that the section 401(m) safe harbor does not apply to employee contributions. Thus, a plan that provides for employee contributions and matching contributions must satisfy the ACP test, even though the matching contributions satisfy the section 401(m) safe harbor requirements. The proposed regulations would adopt the rules set forth in Notice 98-52 permitting plans to disregard all matching contributions with respect to all eligible employees for purposes of the ACP safe harbor. Finally, the preamble states that the IRS and Treasury are considering the extent to which the notice to eligible employees under section 401(k)(12)(D) — as well as other notices under various plan-related Code requirements — can be provided electronically, taking into account the Electronic Signatures in Global and National Commerce Act (E-SIGN).14 The 12 See Institute Memorandum to Pension Members No. 3-00 and Pension Operations Advisory Committee No. 2-00 (11530), dated January 7, 2000 (Notice 2000-3); Institute Memorandum to Pension Members No. 66-98 (10438), dated October 30, 1998 (Notice 98-52). 13 Thus, the rate of match for purposes of determining whether an HCE has a higher matching rate is based

only on matching contributions with respect to elective contributions under the safe harbor plan. 14 See Institute Memorandum 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 (12402), dated July 28, 2000. 6 preamble further notes that Treasury and the IRS anticipate issuing proposed regulations on these issues and invite comments on them. Until such regulations are issued, employers may continue to rely on the interim guidance provided in Notice 2000-3. Proposed Effective Date. The regulations are proposed to apply for plan years beginning no sooner than 12 months after the regulations are finalized. Thomas T. Kim Associate Counsel

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