

January 2005

Final 401(k) Regulations: Confirming a lot, Changing a Little

On December 29, 2004, the IRS issued final regulations governing 401(k) plans (the "Regulations"). The Regulations set forth a comprehensive revision of the rules applicable to 401(k) plans and reflect statutory changes since 1994, when the IRS last issued final regulations. For the most part, the Regulations follow guidance contained in proposed regulations issued in 2003, but do contain some modifications. The purpose of this Management Alert is to re-cap the significant provisions of the proposed regulations and summarize the changes made to these provisions by the Regulations. Our summary of the proposed regulations can be viewed by clicking here.

The Regulations are effective for plan years beginning on or after January 1, 2006. However, plan sponsors may elect to apply the new regulations for plan years ending after December 29, 2004 (generally, plan years 2004 or 2005), if all the provisions of the Regulations are applied to the plan, to the extent applicable.

Prefunded and Targeted Contributions Banned

As with the proposed regulations, the Regulations eliminate two practices that the IRS views as "abusive" - prefunding and targeted contributions. "Prefunding" involves making contributions to a 401(k) plan before the employee earns the compensation, in order to accelerate the employer's tax deduction and permit more employee tax-deferred earnings. The Regulations retain the proposed rule that contributions may not be deposited into the plan before the employee has earned the underlying compensation. At the request of several commentators, however, the Regulations include an exception for the occasional bona fide administrative consideration, as long as the early contributions are not made for the principal purpose of accelerating deductions. The Regulations also include an exception to the prefunding restriction for forfeitures and for certain contributions that result in a matching allocation of employer securities released from encumbrance under a securities acquisition loan in a leveraged employee stock ownership plan (ESOP). The Regulations also clarify that the new rules regarding the timing of contributions are not intended to prevent self-employed individuals from deferring amounts that are paid to the individuals throughout the year on account of services performed during the year.

"Targeted" (or "bottom-up") contributions are often used by plans that fail the nondiscrimination test as an alternative to distributing the excess to highly compensated employees (HCEs). In particular, they are additional employer contributions made first to the employees with the lowest compensation. Under this method, small contributions result in a large percentage of deferrals for such employees, enabling the plan to pass the nondiscrimination test at a relatively small cost. The Regulations continue to provide that

employer contributions can only be used if they are made on a uniform basis to all non-HCEs (NHCEs). There is an exception for employer contributions to an NHCE that do not exceed 5% of compensation. Employer contributions to an NHCE that do exceed 5% of compensation can be taken into account under the actual deferral percentage test only if additional requirements are met.

New Guidance on Safe Harbor Plans

The Regulations contain the detailed guidance on safe harbor plans, which require a minimum level of either matching or nonelective contributions to exempt the plan from nondiscrimination testing. The guidance generally makes safe harbor plans more attractive to employers by providing more flexibility. For example, the Regulations clarify that a plan that begins the year as a safe harbor plan can be amended to eliminate the safe harbor match if necessary, and conversely that a plan can, in some cases, be amended to add a safe harbor provision up to 30 days prior the end of the year. The proposed regulations, however, did not specify whether an exception to the requirements for safe harbor matching contributions with respect to catch-up contributions. Upon consideration, the IRS determined that such exception would be inappropriate, and, thus, no exception is provided under the Regulations.

Distributions and Withdrawals

The Regulations conform to the EGTRRA rule for hardship distributions by shortening the period of employee suspension from making contributions from one year to six months. The Regulations also make it clear that the plan may rely upon the employee's written representation that he or she has no other sources of funds to meet the hardship, unless the plan administrator has actual knowledge that the representation is false. In addition, the employee need only represent that he or she cannot obtain a commercial loan in the full amount necessary to meet the hardship, and need not agree to obtain such a loan if one is not available on reasonable commercial terms.

The Regulations provide significant modifications to the proposed regulations on hardship distributions. In order to receive a hardship distribution, a participant must have obtained all distributions currently available under all qualified plans of an employer, including distributions of dividends from an ESOP that allows a dividend pass-through election. The Regulations adopt the provisions in the proposed regulations that clarify certain ambiguities, such as those relating to what constitutes an immediate and heavy financial need, but add funeral expenses and certain expenses relating to the repair of damage to the employee's principal residence to the list of events that constitute immediate and heavy financial needs.

The Regulations address the recent narrowing of the definition of

“dependent” under the Internal Revenue Code, which, for example, requires dependents to be unmarried and not have any dependents of their own. Briefly, the Regulations disregard the narrowed provisions of the revised definition and, thereby, allow medical expenses and post-secondary educational expenses for an employee, spouse, or dependent (even if, for example, the dependent is married or has dependent children) to be treated as a heavy financial need for hardship distribution purposes. The Regulations also expand the definition of dependent for medical expenses (other than for nonprescription drugs or medicine) to include certain non-custodial children.

As with the proposed regulations, the Regulations eliminate the “same desk rule” that restricted employees from receiving distributions upon termination of employment if they continued to work for a successor to the business. The proposed regulations, however, left open whether the same desk rule would continue to apply to employees who are converted to leased employees through outsourcing. After consideration, the IRS determined a common law employee who becomes a leased employee should not be considered to incur a severance from employment and, thus, such a change in status is not included in the list of distributable events.

Automatic Enrollment Plans

The Regulations explicitly approve the use of automatic enrollment in a plan and allow the plan to treat participants as having elected a basic contribution level, unless they affirmatively opt out. However, the Department of Labor has taken the position that an employee will not be treated as having chosen the default investment option under a plan just because the employee does not make a different election. This underlines the necessity of providing for prudent investment of the accounts of employees who do not make their own investment election.

Miscellaneous Changes

The following is a summary of other changes made by the proposed and final regulations:

- ♦ **Inclusion of ESOPs.** The Regulations provide that a plan which includes an ESOP will combine the ESOP and non-ESOP portions for nondiscrimination testing purposes. This is useful for KSOPs in which HCEs tend to invest more heavily in employer stock. The class of employees eligible to participate in the ESOP and non-ESOP portions, however, must still be nondiscriminatory.
- ♦ **Distributions Upon Plan Termination.** The Regulations add to the list of plans that an employer may maintain following the termination of a 401(k) plan and still permit distributions from the 401(k) plan to include ESOPs, SEPs, SIMPLE IRAs, Code Section 403(b) plans and Code Section 457 plans.
- ♦ **Contingent Benefit Rule.** The Regulations allow an employer to restrict elective contributions to amounts available to a participant after withholding for income and employment taxes.
- ♦ **Highly Compensated Employees (HCEs) who Participate in More than One Plan.** The actual deferral ratio for each HCE who participates in more than one cash or deferred arrangement is determined by aggregating the HCE’s elective contributions that are within the plan year of the cash or deferred arrangement being tested.
- ♦ **Recharacterization of Excess Contributions.** If excess contributions of less than \$100 are recharacterized as after-tax contributions rather than being distributed, it may be reported as taxable income in the year of the correction, so that an amended Form W-2 is not required.
- ♦ **Prior Year Testing.** The Regulations permit a plan to be inconsistent with the choice of testing methods (i.e. current year or prior year) for ADP and ACP purposes. However, if a plan does not use the same method for both ADP and ACP purposes, contributions may not be moved between the ADP and ACP tests.
- ♦ **Changing Nondiscrimination Testing Methods.** The Regulations contain an anti-abuse rule preventing plans from making repeated changes to testing procedures or plan provisions that have the principal purpose of distorting or manipulating the nondiscrimination testing under Code Sections 401(k) and 401(m).

If you have any questions about 401(k) plans, please contact the Seyfarth Shaw Employee Benefits Group attorney with whom you work or any employee benefits attorney listed on the website at www.seyfarth.com.

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