SEYFARTH SHAW

MANAGEMENT ALERT

July 2003

401(k) Rules Restated With Some New Twists

The IRS last updated its regulations governing 401(k) plans in 1994. A lot has happened since then, including enactment of catch-up contributions, the growth of automatic election plans, and numerous changes to the discrimination rules. The IRS has issued periodic guidance concerning these changes, but the basic 401(k)/401(m) regulations have not kept up.

On July 16, the IRS proposed a comprehensive revision of 401(k)/401(m) regulations ("Proposal") which reflect statutory changes and incorporate, in large part, prior regulations and previously-issued guidance. Most of the changes, particularly to the nondiscrimination rules, are technical in nature and primarily of concern to recordkeepers. The IRS has asked plans sponsors and recordkeepers to comment on points where the Proposal might have the unintended effect of requiring a change to plan systems or practices. The Proposal will not take effect until at least twelve months after its final adoption which, as a practical matter, will not be before the 2005 plan year at the earliest.

Prefunding and "Targeted" Contributions Banned

The Proposal would eliminate two practices that the IRS regards as abusive: "prefunding" contributions and using "targeted" contributions to cure nondiscrimination failures. "Prefunding" is the practice of making contributions to a 401(k) plan before the employee earns the compensation, in order to accelerate the employer's tax deduction and allow employees to earn more tax-deferred earnings. The Proposal provides specifically that 401(k) contributions may not be deposited into the plan before the employee has earned the underlying compensation.

"Targeted" or "bottom-up" contributions have been used by some plans that failed the nondiscrimination test as an alternative to distributing the excess to highly compensated employees (HCEs). Targeted contributions are additional employer contributions made first to the employees with the lowest compensation - often part-time employees or those employed only for a short portion of the year. Even small contributions result in a large percentage deferral for such employees, enabling the plan to pass the nondiscrimination test at a relatively small cost. The Proposal provides that employer contributions can only be used if they are made on a uniform basis to all non-HCEs. There is an exception for employer contributions that do not exceed 5% of compensation.

New Guidance on Safe Harbor Plans

The Proposal gives detailed guidance on safe harbor plans, which provide a minimum level of either matching or nonelective contributions to exempt the plan from nondiscrimination testing. For the most part, the Proposal is helpful and will make safe harbor plans more attractive to employers. For example, the Proposal clarifies 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 to the end of the year. Whether a safe harbor plan is required to match catch-up contributions is unresolved, and the IRS has asked for input on this question.

Distributions and Withdrawals

The Proposal incorporates the EGTRRA rule for hardship distributions, shortening the period of employee suspension from making contributions from one year to six months. As an alternative, to suspension, the Proposal also makes 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 sponsor has actual knowledge that the representation is false. The requirement has been modified so that the employee must only represent that he or she cannot obtain a commercial loan in the full amount necessary to meet the hardship but does not need to agree to obtain such a loan, if not available on reasonable commercial terms.

The Proposal also incorporates the elimination of 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. However, the IRS left open whether any version of the same desk rule would continue to apply to employees who are converted to leased employees through outsourcing. The IRS has asked for comments on this issue.

Automatic Enrollment Plans

The Proposal eliminates the requirement of a written salary reduction agreement, which has been rendered obsolete by the use of electronic enrollment methods, and also formally approves the use of automatic enrollment plans, in which employees are deemed to have elected a basic contribution level unless they affirmatively

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opt out. These arrangements, first approved by the IRS in 2000, have proved a popular way to increase participation. However, the IRS pointedly notes in the preamble to the Proposal that the Department of Labor continues to take 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 Proposal:

- *Inclusion of ESOPs*. Under the Proposal, a plan that includes an employee stock option plan ("ESOP") will combine the ESOP and non-ESOP portions for nondiscrimination testing. This will be helpful for plans in which HCEs tend to invest more heavily in employer stock. However, the class of employees eligible to participate in the ESOP and non-ESOP portions must still be nondiscriminatory.
- *Distributions Upon Plan Termination.* The Proposals 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. The list now includes an ESOP, a SEP, a SIMPLE IRA, a Code Section 403(b) plan and a Code Section 457 plan.
- *Contingent Benefit Rule*. Under the Proposal, an employer may restrict elective contributions to amounts available to a participant after withholding for income and employment taxes.
- *Highly Compensated Employees who Participate in More than One Plan*. In the case of a HCE who participates in more than one 401(k) plan, the Proposal modifies nondiscrimination testing to provide that the average deferral ratio of each HCE is determined by aggregating his or her elective contributions under all of the plans. In addition, the amount of excess contributions distributed to HCEs will be determined by aggregating the contributions under all plans.
- *Recharacterization of Excess Contributions.* If excess contributions are recharacterized as after-tax contributions rather than being distributed, and if the amount of the recharacterized contribution does not exceed $100, it may be reported as taxable income in the year of the correction, so that an amended Form W-2 is not required. Under the present regulations, this $100 *de minimis* rule applies only to distributions and not to recharacterizations.
- *Prior Year Testing*. The Proposal permits 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 testing, contributions may not be moved between the ADP and ACP tests.
- *Changing Non-discrimination Testing Methods*. The Proposal contains anti-abuse provisions preventing plans from making repeated changes in testing methods for purposes of manipulating the nondiscrimination rules under Code Sections 401(k) and 401(m).

Anyone who wishes to comment on the proposed regulations or to request to speak at the public hearing scheduled for November 12, 2003 must contact the IRS no later than October 22, 2003.

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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