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

June 30, 2005

On December 29, 2004, the Internal Revenue Service (“IRS”) issued final regulations governing 401(k) plans that consolidate and simplify previous guidance and reflect certain legislative changes. The final regulations are effective for plan years beginning on or after January 1, 2006, though a plan sponsor may adopt the 401(k) regulations for plan years beginning on or after December 30, 2004, provided that the plan sponsor applies all the rules of the final regulations, to the extent applicable, for that plan year and all subsequent plan years. For collectively-bargained plans, however, the final 401(k) regulations do not take effect until the later of the first plan year commencing on or after January 1, 2006, and the expiration of the last collective bargaining agreement in effect on January 1, 2006.

Set forth below are the highlights of the final regulations.

Strict Limitations on the Prefunding of Contributions

Under the final regulations, elective deferral and matching contributions, generally, cannot be funded before the services to which the contributions relate are performed. Therefore, an employer may not prefund contributions to accelerate the deductions, as had been permitted under IRS Notice 2002-48. The final regulations, however, permit the prefunding of contributions, provided that such prefunding is not for the principal purpose of accelerating tax deductions, and provided that such prefunding meets one of the following three exceptions:

- Occasional early contributions made for bona fide administrative consideration (e.g., the temporary absence of the bookkeeper responsible for transmitting contributions);
- Forfeitures that are allocated as matching contributions; and
- Matching allocations of shares from the suspense account of a leveraged employee stock ownership plan (an “ESOP”) when the contribution is for a required payment due under the loan terms.

Changes to Contributions in connection with Nondiscrimination Testing

The final regulations continue to permit the incorporation by reference of the Actual Deferral Percentage Test (“ADP Test”) and the Actual Contribution Percentage Test (“ACP Test”), though the plan must specify which optional choice applies (e.g., applicable safe harbor method, current or prior year testing). A safe harbor plan that does not meet the safe harbor requirements may not provide for “fall-back” ADP testing.
Anti-Abuse Rules: The final regulations retain the anti-abuse regulations published in the proposed regulations. Under these rules, a plan sponsor may not make changes in testing elections or procedures to cause the plan to pass nondiscrimination testing. These rules are broadly drafted and, therefore, plan sponsors should exercise care in determining whether a change in the testing process may be viewed as abusive.

Restrictions on Targeted QNECs and QMACs: Under the old regulations, an employer may correct a failed ADP or ACP nondiscrimination test by making a “qualified nonelective employer contribution” (“QNEC”) or a “qualified matching contribution” (“QMAC”). A number of allocation methods are available to employers. One such method is the “targeted” QNEC or QMAC method, pursuant to which the employer makes additional contributions to one or more “non-highly compensated employees” (“NHCEs”) having the lowest compensation. The final regulations clarify that, for plans using prior year testing, QNECs and QMACs for NHCEs must be contributed to the plan no later than the end of the plan year being tested. In addition, as explained in the following two paragraphs below, the final regulations restrict an employer’s ability to make targeted QNECs and QMACs.

Under the final regulations, QNECs for an NHCE that exceed the greater of 5% (10% if the QNEC is made in connection with an employer’s obligation to pay prevailing wages under the Davis-Bacon Act or other similar legislation) or two times the plans’ “representative contribution rate” (as defined in Treas. Reg. §§ 1.401(k)-2(a)(6)(iv) and 1.401(m)-6(v)) will be disregarded for testing purposes. QNECs that do not exceed 5% (or 10% as noted above) of an NHCE’s compensation may be taken into account without regard to restrictions on targeted contributions. Because QNECs may be taken into account under the ADP or ACP test, QNECs of up to 10% of an NHCE’s compensation may be permissible.

Under the final regulations, QMACs to a highly-compensated employee (an “HCE”) will be disregarded for testing purposes when those QMACs exceed: (i) the greater of 5% (or 10% as noted above); (ii) 100% of elective deferrals; or (iii) two times the plans’ “representative matching rate” (as defined in Treas. Reg. § 1.401(m)-5(ii)(B) and (C)).

Safe Harbor 401(k) Plans: Under the final regulations, a safe harbor 401(k) plan does not need to satisfy the ADP Test or the ACP Test if such plan contains a safe harbor QNEC formula or a safe harbor QMAC formula. The plan must specifically state the amount of the contribution and specify whether it uses a QNEC or QMAC method. In addition, under the final regulations, elective deferrals under a safe harbor 401(k) plan cannot be taken into account for ACP testing purposes.

Other Noteworthy Changes: The final regulations provide the following:

► The final regulations eliminate the requirement that ESOP and non-ESOP portions of a plan be disaggregated for ADP and ACP testing purposes (but not for other nondiscrimination testing purposes such as testing under Sections 410(b) and 401(a)(4)) of the Internal Revenue Code of 1986, as amended (the “Code”).
The income earned on excess contributions (as determined under the ADP and ACP tests) during the “gap period” (which is the period after the close of the plan year but prior to the distribution) must be distributed along with the excess contributions. The final regulations also provide a “safe harbor” for calculating gap period income that provides that the amount of the distribution may be determined up to 7 days before the distribution.

The existing rule on the aggregation of an HCE’s deferrals, matching contributions and employee contributions for purposes of determining an HCE’s deferral ratio and contribution ratios under the ADP and ACP tests is retained. The final regulations also provide additional rules on how to aggregate contributions under plans with different plan years.

Plans may use current year testing for one test (e.g., ACP) and prior year testing for another test (e.g., ADP), subject to certain restrictions.

**Safe Harbor 401(k) Plans**

Twelve-Month Plan Year Requirement: Generally, a safe harbor 401(k) plan must be adopted before the beginning of the plan year and be maintained throughout the full 12-month plan year. A short plan year is permitted under the following circumstances:

- The plan terminates, the plan satisfies the safe harbor requirements through the date of termination, and the termination is on account of a substantial business hardship (comparable to a business hardship described in Code Section 412(d)), or a merger or an acquisition transaction (described in Code Section 410(b)(6)(C)).

- The plan terminates, the plan satisfies the safe harbor requirements through the date of termination, the employees are provided notice of termination of safe harbor contributions, the termination is effective no earlier than 30 days after notice is provided, and the plan passes the ADP test in the year of termination.

- The plan changes its plan year, resulting in a short plan year, and the short plan year is preceded and followed by a 12-month plan year or a 12-month period (provided that, in any such preceding or following year, the plan meets the safe harbor requirements).

Notice: Under the final regulations, the safe harbor notice may be provided electronically. Plan sponsors may rely on IRS Notice 2000-3, until final guidance is provided.

Catch-up Contributions: Under the final regulations, if a plan permits employees to make age 50 catch-up contributions under a safe harbor 401(k) plan that uses QMACs, then to meet the safe harbor matching contribution requirements, the plan must match the catch-up contributions.

ADP and ACP Testing: Rules similar to those described in “Changes to Contributions in connection with Nondiscrimination Testing – Safe Harbor 401(k) Plans” apply.
Vesting

Elective Deferral Contributions: The final regulations provide that elective deferrals must be immediately vested and non-forfeitable. In addition, elective deferrals are to be counted in determining whether a participant is “nonvested” under the break-in-service “rule of parity.” (Specifically, under the final regulations, elective deferral contributions disregarded for the purpose of Code Section 411(a)(2) are disregarded for the purpose of that statutory provision only and not for other Code Section 411(a) purposes (e.g., the rule of parity in Code Section 411(a)(6)(D)(iii)). Therefore, under the final regulations, a 401(k) plan that previously disregarded service and unvested matching contributions before a 5-year break in service is no longer permitted to do so.

Hardship Distributions

Prior to the final regulations, the list of hardship distributions included the following:

- an immediate and heavy financial need if the distribution is for certain medical expenses;
- the purchase of a primary residence;
- payment of tuition and related educational fees; and
- the prevention of foreclosure or eviction.

The final regulations expand the list of safe harbor hardship events to include:

- burial or funeral expenses for the employee’s deceased parent, spouse, children or dependents; and
- expenses for repair of damage to an employee’s principal residence that would qualify as deductible casualty expenses (without regard to the 10 percent “floor” on deductibility).

In addition, the final regulations allow an employee to represent that he or she has an immediate and heavy financial need in writing or in “such other form as may be prescribed by the Commissioner.” Thus, presumably, future IRS guidance will address the use of electronic media.

Elections to Contribute

The final regulations require 401(k) plans to provide an employee with an “effective opportunity” to make or change a cash or deferred election at least once each year. The determination of whether an “effective opportunity” exists depends on all the relevant facts and circumstances, including the adequacy of the notice of the availability of the election, the period of time during which the election can be made, and any other conditions imposed on elections. With respect to automatic enrollment, a plan sponsor has flexibility in determining the default contribution percentage under an automatic enrollment provision.

In addition, the final regulations relax the one-time irrevocable election requirement by eliminating the requirement that a one-time irrevocable election be made upon commencement of employment. Rather, a one-time irrevocable election must be
made at the time that an employee becomes eligible under any plan maintained by the employer, including qualified, 403(b), 457(b), SEP and SIMPLE plans.

**Other Noteworthy Changes**

Severance from Employment: The final regulations provide that a change in status from a common law employee to a leased employee does not constitute a severance from employment.

Distributions following Plan Termination: The final regulations provide that the maintenance of an ESOP, SEP, SIMPLE IRA, 403(b), 457(b) or 457(f) plan will not prevent a distribution on the termination of a 401(k) plan.

Self-employed Individuals: Under the final regulations, self-employed individuals (e.g., partners and sole proprietors) may make deferrals on cash advance payments paid during the plan year if the payments are based on the individual’s services before the date of payment and if the payments do not exceed a reasonable estimate of the individual’s earned income for the taxable year.

**Areas Not Covered by the Final Regulations**

The final regulations include placeholders, indicating that future guidance will be forthcoming, on mergers, acquisitions and similar events and Roth 401(k) plans. In addition, the final regulations do not address the timing of plan amendments where a plan is amended from current year testing to prior year testing. Also not addressed are rules relating to post-severance contributions for plan participants. Nor do the final regulations indicate when plans are to be amended to reflect the changes made by the final regulations.

**Conclusion; Further Information**

Plan sponsors should review the final regulations now to determine which of the many changes affect their plans. Plan sponsors also need to decide whether to apply the final regulations as of the first plan year beginning on or after January 1, 2006, or earlier. If earlier, then plan sponsors must remember to apply all the applicable provisions of the final regulations. If plan sponsors choose to apply the final regulations in the middle of the plan year, then they must ensure that all provisions are observed in operation as of the beginning of that plan year.

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