Be Careful What You Wish For: The Proposed 401(k) Regulations Are Here!

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It is good to have additional guidance about 401(k) plans. Nonetheless, much of the proposed regulations appear likely to make administering these plans more complicated, and plan administrators are left with no resolution to commonly asked questions. It will be interesting to see how much credence the government gives to practitioner written and oral comments about these rules.

The last time that Treasury issued comprehensive regulations to Internal Revenue Code Section 401(k) was 1991. These regulations were modified somewhat for changes in the law in 1994. Since that time, however, practitioners have received a collection of more informal guidance addressing issues resulting from legislative changes, and the actual regulations have become increasingly obsolete. [*See, e.g.,* Notice 97-2, 1997-1 C.B. 348; Rev. Proc. 97-9, 1997-1 C.B. 624; Notice 98-1, 1998-1 C.B. 327; Notice 98-52, 1998-2 C.B. 672; Notice 2000-3, 2000-1 C.B. 413; Rev. Rul. 2000-8, 2000-1 C.B. 617; Notice 2001-56, 2001-2 C.B. 277; Notice 2002-4, 2003-2 I.R.B. 298]

As a result, the Treasury attempted to update the regulations, incorporating the various less formal items of guidance and anticipating changes that become effective in the future under the Economic Growth and Tax Relief Reconciliation Act of 2002 (EGTRRA). This is good. Unfortunately, the Treasury has also examined some issues that many do not see as problematic and has endeavored to fix what many believe was not broken. That is likely bad. This article will examine the proposed regulations, including the good, the bad, and the items that the IRS doesn't want to talk about … at least, in this set of regulations.

Effective Date of Regulations

Practitioners can breathe a sigh of relief that any new rules in the proposed regulations will affect neither the 2003 nor 2004 calendar-year testing cycles. The proposed regulations will become effective only for plan years that begin at least 12 months after they are publicized in final form. Given the scope of the guidance and the nature and timing of public comments, it is unlikely that Treasury will issue the final regulations before mid-2004. This means that the earliest effective date for calendar year plans will likely be January 1, 2006.

Unlike many other proposed regulations, the new proposed 401(k) regulations do not contain a provision permitting plan sponsors to apply the proposed rules in the interim before finalization. As a result, any favorable provision in the proposals is delayed, as well as those items that are greeted with less enthusiasm. The preamble to the proposed regulations indicates that Treasury will consider permitting practitioners to apply the final rules immediately upon their publication, even if the required effective date is at least 12 months later. However, it is not anticipated that a plan sponsor will be permitted to pick and choose which portions of the regulations to apply early—that is, early application of the final regulations is likely to be an all or nothing deal.

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What Happens in the Meantime?

Treasury requested that written comments be presented by October 22, 2003. Several organizations filed comments, including the American Society of Pension Actuaries, the American Institute of Certified Public Accountants, and some law firms. A public hearing was held on November 12, 2003.

In the meantime, it is business as usual. Practitioners should continue to follow the rules currently in place without regard to the proposed regulations. Nonetheless, one should keep a weather eye on the proposed regulations and their progress to consider what actions must be taken if the rules are adopted as proposed.

On the Plus Side: Things We Like

If adopted as final, the proposed regulations bring certainty, and in some cases simplification, to a number of issues that are routinely faced in plan administration. Practitioners will likely consider the following clarifications as positive developments:

Dissimilar Testing Methods for ADP and ACP

The proposed regulations confirm that a plan can use current year testing for the ADP test and prior year testing for the ACP test or vice versa. The proposals also clarify that contribution-shifting techniques are not available if different methods are used for the two tests. The proposals do not change the current requirement that prototype plans use identical testing methods [Rev. Proc. 2000-20]. This will likely need to be addressed separately with the IRS representatives who administer the determination letter program.

ESOP Dividends Not a CODA

Current ESOP rules permit dividends paid to the plan by the plan sponsor to be tax deductible if they are available to participants for cash distribution. This choice by the participants between taking the dividends in cash and having them remain in the plan has the appearance of a cash or deferred election. The proposed regulations clarify that this dividend election does not constitute a cash or deferred election and the dividends that remain in the plan are not treated as elective deferrals.

Required Disaggregation of ESOP Eliminated

Under current law, the portion of a 401(k) plan that contains an ESOP feature must be mandatorily disaggregated from the non-ESOP portion of the plan for ADP and ACP testing. This has produced significant consternation for ESOP-401(k) combinations (also known as KSOPs), which are becoming increasingly widespread. The disaggregation requirement causes KSOP sponsors to test 401(k) deferrals that are part of the ESOP (*i.e.*, invested in employer securities) separately from those that are not part of the ESOP. This makes testing harder to perform and often harder to pass for these plans. In recognition of the problematic result this produces, the proposed regulations would eliminate mandatory disaggregation of the ESOP and non-ESOP portions of a plan for ADP and ACP testing purposes. This change in the mandatory disaggregation rules would not modify the rules that apply to coverage testing under Code Section 410(b).

Hardship Withdrawals

The proposed rules still contain a two-pronged test for determining whether a hardship distribution is warranted—that is, there must be an immediate and heavy financial need (the "events test") and the distribution must be necessary to satisfy the need (the "needs" test). The proposed regulations also retain both a general standard for each test, as well as a safe harbor (or "deemed") standard. A plan may mix and match these standards—that is, it may follow the general standard for events testing and the safe-harbor standard for needs testing. Prototype plans are required to use the safe-harbor standards.

Current regulations permit an employee to represent in writing to the plan administrator that the needs test has been met—that is, that he or she cannot get the funds from any other source. However, the preamble to the proposed regulations, as well as the language of the proposals themselves, make a small change to the needed representation. In particular, if no loan is available from a commercial source that would completely relieve the hardship, the participant does not have to attest that he or she has obtained all available loans from commercial sources.

Unfortunately, Treasury did not include in the proposed regulations that funeral expenses are a "deemed" hardship event. This is surprising, because the final regulations issued for 457 plans (which are in many ways similar to 401(k) plans, but for governmental entities) did include funeral expenses as a qualifying event for their version of hardship withdrawals.

Distributions Following Plan Termination

Code Section 401(k)(10) and the existing regulations prohibit distributions of elective deferrals from terminated plans under certain circumstances. Under the current rules, these circumstances include situations where the employer maintains or adopts a successor defined contribution plan within certain time frames. This limitation remains in the proposed regulations, with two modifications. In the proposals, the phrase "alternative defined contribution plan" replaces the "successor defined contribution plan" terminology, and the list of such plans has been expanded to include not only ESOPs and SEPs but also SIMPLE IRA plans, 403(b) plans/contracts, and 457 plans.

Distribution Restrictions on Plan Transfers

The proposed regulations clarify that the withdrawal restrictions applicable to elective contributions, QNECs, and QMACs must be retained in the recipient plan if the amounts are part of a plan-to-plan transfer. These restrictions prohibit distributions of these accounts prior to the earlier of age 59-1/2, severance from employment, death, retirement, or disability.

HCEs in More Than One Plan

If an HCE participates in more than one plan of the same employer, the actual deferral ratio (ADR) and actual contribution ratio (ACR) for either plan must include all deferrals or matching and employee contributions contributed for the HCE in any plan within the plan year, as well as all compensation paid by the employer during that period. The proposed regulations clarify how this is done if the plans have different years. Under the proposal, a given plan's ADR will include all deferrals to either plan during the 12-month plan year period, divided by the compensation paid by the employer during that same 12-month period. The ACR is similarly calculated, using the matches and employee contributions to either plan during that 12-month period. As a result, if the plans have different years, HCEs will have different ADRs and ACRs.

For example, suppose Harvey, an HCE, is eligible to participate in Plan A and Plan B of a given employer. Plan A has a July 1 through June 30 plan year. Plan B has a calendar year. During each month in 2006, Harvey earns $10,000 in compensation and defers $500 to Plan A and $400 to Plan B. During each month in 2007, Harvey earns $11,500 in compensation and defers $700 to Plan A and $550 in Plan B.

For the ADP testing for the July 1, 2006, through June 30, 2007, plan year for Plan A:

- Harvey was paid $10,000 per month for 6 months and $11,500 for 6 months, for a total applicable compensation of $129,000.
- Harvey deferred $900 ($500 to Plan A and $400 to Plan B) for 6 months, and $1,250 ($700 to Plan A and $550 to Plan B), for a total deferral of $12,900.
- Therefore, Harvey's ADR is $12,900/$129,000 or 10 percent for Plan A.

  For the ADP testing for the calendar year 2006 for Plan B, Harvey's ADR is $10,800 [$900 x 12], divided by $120,000, or 9 percent. For calendar year 2006, Harvey's ADR for Plan B is $15,000 [$1,250 x 12], divided by $138,000, or 10.87 percent

Similarly, if the two plans use different definitions of compensation, the denominator of the ADR or ACR for a given plan will be based on the compensation definition for that plan.

Notice 98-1 Double Counting Rules Simplified

The concept of double counting became an issue under the Small Business Job Protection Act (SBJPA), which permitted ADP and ACP tests to use prior year results for NHCEs. The Treasury was concerned that a deferral or QNEC could end up counting in the ADP or ACP test for two successive years. For example, suppose a QNEC is made and used to determine the ADP for the nonhighly compensated employees (NHCEs) under current year testing in 2000. That same QNEC could be used again in 2001 when the employer switched to prior year testing for that year. The existing rules prohibit this, and that prohibition is retained under the proposed regulations.

Easing of Plan Year Rules for Safe Harbor Plans

Under current rules, a plan using the ADP or ACP safe harbors cannot have a year that is shorter than 12 months, unless the plan is established mid-year and the safe harbor rules are adopted when the plan is first effective. This prevents a safe harbor plan from changing plan years or from terminating mid-year.

The proposed regulations allow a plan sponsor to adjust its plan year without losing safe harbor status. A short plan year created by amendment would be permitted so long as the short plan year is flanked by two full plan years, both of which also use the safe harbor rules.

> **Example.** A safe harbor plan has a plan year that runs from October 1, 2006, through September 30, 2007. The plan is amended to change the plan year to a calendar year, effective October 1, 2007. This would produce a short year from October 1, 2007, to December 31, 2007, followed by a full calendar year in 2008. Because the plan is a safe harbor plan for the 12-month years before and after the short year, it may use safe harbor testing for the short year, as well.

The proposals permit the final plan year of a terminated or merged safe harbor plan to be less than 12 months.

A plan sponsor of a plan that is terminating mid-year has two options for retaining the safe harbor in the year of termination. If the plan uses the matching contribution to satisfy the safe harbor, the sponsor can opt out of making the matching contributions as of the mid-year termination and revert to the ADP/ACP testing for the short year. If that is done, the sponsor must provide notice of the opting out to participants and provide the safe harbor matching contribution through the notice period. This choice is not available to a plan that has committed as of the first day of the (short/final) plan year to the 3 percent nonelective contribution to satisfy safe harbor.

Alternatively, the plan can maintain its status as a safe harbor plan in the final year if the termination occurs on account of a business transaction covered under Code Section 410(b)(6)(C), or if the employer experiences a substantial business hardship.

On the Negative Side: Things We're Not Crazy About

Notwithstanding the stated goal of the regulations, which is to consolidate existing guidance, the preamble indicates that a review of the existing rules gave Treasury representatives some occasions for pause. As a result, the proposed regulations embody some changes from existing guidance, and those changes are not always in a positive direction. In fact, several will complicate a plan administrator's job, often for very little purpose or effect.

No "Prefunding" of Deferrals

The Treasury and the IRS have historically expressed some concerns about the prefunding of salary deferrals, particularly when such prefunding occurred in a tax year before the deferral amounts would have otherwise been paid. In its Notice 2002-48, the IRS advised that it was considering further guidance on the subject but indicated that it would not challenge the deductibility of prefunded contributions so long as actual payment is made during the taxable year for which the deduction is claimed and the amount is within statutory limits.

The proposed regulations show that IRS and Treasury have concluded that prefunding of elective contributions and matching contributions is inconsistent with Code Sections 401(k) and 401(m). The proposed rules provide that any deferrals or matching contributions deposited *before* the earlier of the date on which the related services are provided or the date on which the amount would otherwise be paid to the participant will be treated as non-elective (*i.e.*, profit sharing) contributions. Such amounts must therefore be allocated to participants' accounts according to the profit sharing formula in the plan.

The result of this proposal would be to catch plan sponsors between a rock and a hard place. If the deferral goes in too late (which may be simply days), the sponsor is subject to prohibited transaction taxation under the DOL's rules for plan assets. [DOL Reg. § 2510.3-102] If the deferral goes in too early, it is likely to be considered a profit sharing contribution by the IRS. This can affect reasonable plan sponsor practices such as making an early deposit before the payroll clerk goes on a two-week vacation. Furthermore, the prohibition of early contributions applies whether or not the effect is to contribute in a tax year before the payroll would normally be paid.

Another adverse result of this proposal relates to "negative deferrals." In practice it is possible for a deferral amount to be deposited to a participant's account in error. The customary correction is for the plan sponsor to reduce the deposit for the following payroll period by an equivalent amount. This is, in essence, an overcontribution in the first payroll period with an equivalent offset the following payroll period. Under the proposed regulations, the overcontribution in the first period would constitute a profit sharing contribution, allocable to all participants as a profit sharing contribution.

The proposed regulations reiterate that a partner's or self-employed person's income is treated as received on the last day of the plan year. It is common for partners to defer compensation during the year from their draws or guaranteed payments. If the partner's compensation is not received until year-end, it would appear that these periodic deposits by partners would be prohibited. It is not clear if Treasury intended this effect.

Restrictions on Bottom-Up and Flat Dollar QNECs

The proposed regulations radically reduce the availability of both bottom-up and flat dollar QNECs to resolve ADP and ACP testing failures. While both options remain available, a QNEC allocated to a participant's account may be included in a nondiscrimination test only if it does not exceed the greater of: (a) 5 percent of pay, or (b) twice the "representative contribution rate." The representative contribution rate is equal to the lowest QNEC contribution rate for any NHCE in a group that is made up of either:

- Half of all eligible NHCEs; or
- All NHCEs that are employed at year-end.

Because this test is met separately with regard to the ADP and ACP tests, a QNEC that does not exceed 5 percent can be used in both the ADP and the ACP test, providing a total permissible and includable QNEC for any NHCE of 10 percent.

Example 1. Suppose all NHCEs employed on the last day of the plan year receive a QNEC equal to 12 percent of pay. The full 12 percent QNEC can be used in testing for the ADP or ACP test because the QNEC rate is equal for all participants, satisfying the representative contribution rate requirement..

Example 2. Assume there are 10 NHCEs in an ADP test. Five of these NHCEs receive no QNEC; three others receive a QNEC of 5 percent of pay; and the other two NHCEs receive a 10 percent of pay QNEC allocation. Half the NHCEs is equal to five. Therefore, the representative contribution rate is equal to the lowest rate among any five NHCEs. If we look at the five NHCEs who receive QNECs, the lowest QNEC rate among them is 5 percent of pay. Therefore, the highest includable QNEC for any NHCE is double that, or 10 percent of pay. Because all QNECs are equal to or less than 10 percent, all QNECs are includable in the ADP testing.

Example 3. A 5 percent QNEC is allocated to only two of 20 eligible NHCEs. The full QNEC may be counted in testing because a QNEC of 5 percent or less is always permissible under the proposals.

The impact of these proposals extends beyond the bottom-up or other targeted QNECs. In fact, the proposal makes flat dollar QNECs all but unworkable. The plan administrator would need to determine the contribution rate for each participant, based on the participant's actual compensation, and then evaluate whether any exceeds the greater of 5 percent of pay or twice the representative contribution rate.

Was this impact intended by Treasury? Discussions with IRS representatives at meetings and in webcasts indicate that the answer is "yes." The IRS appears to be concerned about the ability of an employer to give very small dollar amounts to all employees, but to have those small contributions significantly affect ADP or ACP testing due to short time participants. Nonetheless, this represents a significant departure from the IRS's previous position in the Section 401(a)(4) regulations, where a flat dollar allocation to participants is considered to be a safe harbor nondiscrimination formula.

The proposed regulations include a similar limitation on targeted QMACs. Under the proposals, a matching contribution cannot be included in the ACP test if it exceeds the greater of (a) 100 percent of deferrals, or (b) two times the plan's "representative matching rate." The representative matching rate is determined in an analogous fashion as the representative contribution rate—the lowest rate allocated to either half the NHCEs who make salary deferrals or employee contributions or to those who are employed at the end of the year. The matching rate is equal to the matching contributions, divided by the salary deferrals or employee contributions that are eligible for matching.

Example 4. A 401(k) plan provides for QMACs equal to 50 percent of the first 6 percent of pay deferred. All matching contributions may be counted in the ACP test because the matching rate is the same for all employees who receive a matching contribution (and the rate does not exceed 100 percent of deferrals).

Gap Period Income on Corrective Distributions

In a consummate surprise, the proposed regulations eliminate the rule that permits a plan administrator to decline to calculate gap period earnings on refunded deferrals and distributed matches due to failed ADP and ACP tests. The optional methods for calculating the gap period income remain the same as under current law, but the proposed regulations tie the need to calculate the gap period earnings to the timing of earnings allocations under the plan.

As a result, a daily valued plan would always have to determine and return gap period earnings, while plans operating on quarterly or semi-annual valuations would determine gap period earnings only if the corrective distribution occurs after an earnings allocation date under the plan.

Plan Document Issues

The proposed regulations allow some incorporation by reference of the ADP test rules, but it is less clear which ADP and ACP testing elections must be specifically stated in the plan and which can be merely elected administratively. The proposals also fail to specify the timing of amendments changing testing options.

The proposals also provide that a safe harbor plan may not have language under which the plan reverts to ADP or ACP testing if there is a failure to comply with the safe harbor rules.

No Last Day—1,000 Hour Rule for Safe Harbor Matching Contributions

While it has long been understood that any safe harbor match used to satisfy the ADP test could not be conditioned on service, plans routinely have been designed with additional safe harbor matching contribution formulas that require additional hurdles for participants. For example, a plan that provides the 3 percent nonelective safe harbor contribution might also provide a matching contribution equal to 50 percent of deferrals up to 6 percent of pay. That latter contribution, not needed to meet the ADP test, was commonly provided only to participants who worked at least 1,000 hours and remained employed on the last day of the plan year (assuming that group satisfied coverage rules of Code Section 410(b)).

Under the proposed regulations, one of the conditions for a matching contribution to fall within the safe harbor is that all NHCEs must be able to receive the same rate of match as HCEs. If there is a last day or 1,000 hour requirement, it is possible for some NHCEs to receive a lesser contribution than the HCEs, and that fails this requirement.

This may be seen as a change in policy by the IRS. Notice 98-52 provided that a safe harbor match had to be allocated to all "eligible" participants if it was not needed to meet ADP testing. The question was: what did the modifier "eligible" mean in this context? Many practitioners interpreted the language to refer to individuals who were otherwise eligible for the matching contribution, which could be only those participants who were employed on the last day of the year and had completed 1,000 hours of service. IRS representatives now indicate that this was a misunderstanding, and that they never intended for this interpretation to be controlling. The more specific language of the proposed regulations is meant to clear up the misunderstanding.

Anti-Abuse Provision

The proposed regulations make a point of stating that a plan will not satisfy the requirements of Code Section 401(k) if there are repeated changes to plan provisions or testing procedures that have the effect of significantly increasing the permitted ADP for HCEs, "if a principal purpose of the changes was to achieve such a result." While it is unlikely this broad language will be eliminated from final regulations, there is some hope that it will be toned down or narrowed. It can be difficult to anticipate what the IRS will consider a "significant increase" in the permitted ADP for HCEs, given that changes to testing procedures usually occur only when test failures would otherwise result.

. . . And "Let's Not Talk About This"

A few matters never seem to see the light of day. The following issues are not addressed in the proposed regulations, and are therefore likely to be absent from the final regulations, as well:

Entry Date Rule for Testing Otherwise Excludables

The proposed regulations continue the current special testing of early entrants. A plan can use either the rule under Code Section 401(k)(3)(F) that excludes from nondiscrimination testing those NHCEs who have not reached age 21 or completed a year of service, or use the disaggregation rule under Code Section 410(b)(4) to carve out both HCEs and NHCEs who have not met those thresholds. What continues to be left unaddressed is what exactly constitutes an early entrant: is it based on whether the employee would have completed one year of service and attained age 21 by year-end, or whether the participant would have actually entered the plan using either the plan's entry date definition or the maximum permissible entry date under Code Section 410(a)(4). While IRS has informally stated that either approach is a reasonable interpretation of the law, it is time we had official guidance.

Timing of Amendments

The proposed regulations have guidance identical to that of Notice 98-1 relating to when a plan may switch from the current year testing method. The proposed regulations fail to provide guidance, however, on the *timing* of an amendment to change the testing method.

Some IRS representatives have opined historically that amendments must be done before the plan year begins. IRS speakers at recent seminars seem more liberal, indicating that it may be possible to amend a plan anytime during the year to make these types of changes. Many practitioners, however, believe it is important that changes be permitted anytime during the testing period, which could be as long as the end of the following plan year. This permissive timing is critical, some believe, because one never knows what elections should be made until the testing is performed—and, after all, that almost never occurs during the plan year.

It is possible that an amendment to change testing methods after year-end could raise impermissible cutback issues under Code Section 411(d)(6). Suppose, for example, that a plan provides that ADP or ACP testing failures are to be corrected using a QNEC. An amendment after year-end to modify the testing so that it is passed would deny a QNEC to participants who would otherwise be eligible to receive the contribution. While that may militate against permitting amendments after the plan year, it is important to note that there are several testing corrections that would not invoke cutback concerns, such as a reduction or elimination of a refund to HCEs. In that situation, testing period amendments make sense.

Mergers and Acquisitions

It comes as no surprise that the Treasury failed to resolve the outstanding 401(k)-related issues when one company acquires or disposes of another. Sections 1.401(k)-5 and 1.401(m)-4 of the proposed regulations are specifically for "Special rules for mergers, acquisitions and similar events" and are *Reserved*. We continue to be left to our own best judgment about how the various rules should be applied in these settings.

Rev. Rul. 2004-11 was issued as this article goes to press, discussing the Section 410(b)(6) issues in company acquisitions and disposition. This ruling further requested that practitioners send in comments and recommendations relating to benefits issues in company transactions.

Conclusion

It is good to have additional guidance about 401(k) plans. Nonetheless, much of the proposed regulations appear likely to make administering these plans more complicated, and plan administrators are left with no resolution to commonly asked questions. It will be interesting to see how much credence the government gives to practitioner written and oral comments about these rules.