IRS Issues New 401(k) Guidance in the Form of Comprehensive Proposed Regulations

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On July 17, 2003, the Internal Revenue Service ("IRS") issued proposed regulations under Sections 401(k) and (m).[1] The regulations incorporate the many significant changes in the applicable laws since the final regulations under these Sections were last issued in 1991 and amended in 1994. These changes include the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Economic Recovery Act of 2001 and other IRS guidance. In addition, these regulations include some additional and different guidance from the IRS.

If you have any questions regarding how these new proposed regulations could apply to your company's 401(k) plan, please contact Marvin Swift at 602.382.6211 or mswift@swlaw.com or Denise Atwood at 602.382.6297 datwood@swlaw.com.

FOOTNOTE

1 All reference to Sections are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

IRS Reverses Position on Prefunded Contributions

In the proposed regulations, the IRS reversed its position concerning an employer's ability to prefund elective and matching contributions. In Notice 2002-48, the IRS discussed when an employer could deduct elective and matching contributions to a 401(k) plan where the employer's taxable year differed from the plan year. In that Notice, the IRS held that an employer could deduct contributions it paid to the plan before the end of its taxable year in anticipation of elective and matching contributions that were presumed to occur after the end of the employer's fiscal year but before the end of the overlapping plan year.

Under the proposed regulations, the IRS reversed its position in Notice 2002-48 and now takes the position that

elective and matching contributions may only be made after the employee performs services for which the compensation would have otherwise have been paid absent the employee's deferral election. The proposed regulations mandate that contributions an employer makes in anticipation of an employee's future performance of services will not be treated as elective and matching contributions. Additionally, any prefunded elective and matching contributions are disregarded under the actual deferral percentage ("ADP") or the actual contribution percentage ("ACP") tests and will not satisfy any requirement under the plan to provide elective or matching contributions to participants.

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Hardship Distribution – Loans and Other Distributions In Partial Satisfaction of Amount Needed

Under current rules, an employee can receive a hardship distribution if: (i) the participant has an immediate and heavy financial need and (ii) the distribution is necessary to satisfy that need. The proposed regulations retain those requirements, but separate the two requirements. For example, the IRS' previous position was that that an employee need not first seek a loan or other distribution if the loan or other distribution would not satisfy the employee's entire need. However, the proposed regulations change that position and provide that an employee must first request a loan or other distribution from the plan (if permitted) even if the loan or distribution would not completely satisfy the immediate and heavy financial need.

Employers Can Maintain More Types of Plans After 401(k) Plan Termination

An employer may distribute benefits from a 401(k) plan (including elective contributions) upon the plan's termination only if an employer does not establish or maintain any other defined contribution plan post termination. Under current rules, a defined contribution plan includes a profit sharing plan, stock bonus plan, or money purchase pension plan. The proposed regulations expand the list of defined contribution plans an employer can maintain post-401(k) plan termination to include an ESOP, SEP, SIMPLE IRA, Section 403(b) plan or contract, and a Section 457 plan.

ESOP and non-ESOP portions of Plan May be Aggregated for ADP and ACP Testing

Under current rules, an employer may not aggregate the ESOP and non-ESOP portions of a plan for ADP and ACP testing. Consequently, a plan must perform two separate ADP and ACP tests – one for each of the ESOP and non-ESOP portions of a plan. A plan may fail the ADP or ACP test merely because more highly compensated employees may be more (or less) likely to invest in employer stock than nonhighly compensated employees.

The proposed regulations change the current rule and now provide that the ESOP and non-ESOP portions of a plan may be aggregated for ADP and ACP testing. In addition, an employer may also permissively aggregate two separate plans, one that is an ESOP and one that is not, to satisfy the ADP and ACP tests.

ESOPs and non-ESOPs must continue to be disaggregated for purposes of satisfying the minimum coverage tests under Code Section 410(b).

Elective and Matching Contributions Made to Two or More Plans Used in the ADP and ACP Tests Must be From the Same Twelve-Month Period

401(k)(3) provides that if a highly compensated employee participates in two or more 401(k) plans sponsored by the same employer, the actual deferral ratio of the highly compensated employee is calculated by treating all 401(k) plans in which the employee is eligible to participate as one plan. This rule prevents an employer from breaking up a 401(k) plan into two or more separate plans in order to satisfy the ADP and ACP tests.

Under current guidance, elective contributions of a highly compensated employee made to more than one 401(k) plan are aggregated for all plan years that end with or within a single calendar year. This approach may produce inappropriate testing results if the plan years are different because more than 12 months of elective contributions could be included in the employee's actual deferral ratio. The proposed

regulations modify the existing rule by clarifying that the actual deferral ratio for a highly compensated employee is calculated by aggregating the highly compensated employee's elective contributions that are made to all 401(k) plans within the plan year of the 401(k) plan being tested.

Similar changes were made in the proposed 401(m) regulations.

Matching Contributions in Non-Safe Harbor Plans Do Not Have to be Aggregated with Matching Contributions in Safe Harbor Plans

A safe harbor plan under Code Section 401(k)(12) must meet certain requirements concerning the rate of matching contributions made to participants under the plan. The IRS previously took the position in Notice 98-52 that the general rules on aggregating contributions for highly compensated employees eligible under more than one plan with a 401(k) feature would apply. The IRS changed its position in the proposed regulations and stated that such aggregation is not applicable under the ADP safe harbor. As a result, elective or matching contributions on behalf of a highly compensated employee who is eligible to participate in more than one plan sponsored by his or her employer need not be aggregated when determining if the requirement under Code Section 401(k)(12)(B)(ii) has been met for the safe harbor plan. The rate of match under a safe harbor plan is based only on the matching contributions made to that safe harbor plan. However, if an employer utilizes the safe harbor method of satisfying the ACP safe harbor, the rule in Notice 98-52 generally continues to apply.

Nondiscrimination Rules Cannot be Used to Manipulate Testing

The current 401(k) plan testing rules are designed to recognize circumstances under which an employer makes legitimate design changes. However, the IRS provides that the rules cannot be applied in a manner that inappropriately inflates the ADP or ACP for nonhighly compensated participants or manipulates the nondiscrimination 401(k) tests. The proposed regulations have added an anti-abuse provision to provide that a plan will be treated as violating the provisions of 401(k) and (m) if there are repeated changes to plan testing procedures or provisions to distort the ADP or ACP so as to significantly increase the permitted ADP or ACP for highly compensated employees or to otherwise manipulate the nondiscrimination rules.

Bottom Up Leveling Technique Limited

The proposed regulations limit an employer's ability to use a bottom up correction method for making qualified nonelective contributions ("QNECs") to help pass the ADP and ACP tests.

Some employers correct for a failed ADP test by making QNECs to the lowest paid nonhighly compensated employees, thereby significantly increasing the ADP for nonhighly compensated employees. A employer makes a QNEC to the lowest paid nonhighly compensated employee to raise that participant's actual deferral ratio, and as a result, the rate of all nonhighly compensated employees. If the plan still fails the ADP test, the employer makes a QNEC to the next lowest paid nonhighly compensated employee, and continues to make QNECs in this manner, until the ADP test is satisfied. The IRS stated that it is concerned that by using this type of technique, employers may pass the ADP test by making high percentage QNECs to a small number of employees with low compensation rather than providing contributions to a broader group of nonhighly compensated employees.

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As a result, the proposed regulations provide that a QNEC must be made on behalf of at least one-half of all nonhighly compensated employees, or a QNEC for one nonhighly compensated employee may not be more than double the QNEC for any other nonhighly compensated employees.

QNECs that do not exceed five percent (5%) of compensation will always be deemed to satisfy this new requirement. QNECs that exceed five percent (5%) of compensation could be taken into account for purposes of satisfying the ADP test only if certain calculations are met.

The proposed regulations under Section 401(m) contain restrictions on QNECs considered for ACP testing. In addition, the regulations contain a similar limit on targeted qualified matching contributions ("QMACs").

Continued on page 4

Correcting ADP and ACP Failures Through Distributions Where Highly Compensated Employees Participate in More Than One 401(k) Plan

The proposed regulations include a special rule for distributing excess contributions to correct an ADP failure when a highly compensated employee participates in multiple 401(k) plans sponsored by his or her employer.

If a 401(k) plan has failed its ADP test and chooses to make corrective distributions from the plan, it must first determine the total amount of excess contributions that must be distributed under the plan based on high actual deferral ratios. Second, the plan must apportion the corrective distribution among highly compensated employees by calculating each highly compensated employee's total amount of elective contributions. Total elective contributions include not only elective contributions made to the plan undergoing correction, but also elective contributions made to each of the 401(k) plans in which the highly compensated employee participates.

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The highly compensated employee with the highest dollar amount of contributions will receive a corrective distribution of excess contributions first. The corrective contribution must be made in an amount that will reduce the highly compensated employee's contributions to equal the dollar amount of contributions for the highly compensated employee with the next highest dollar amount of contributions. However, the amount of excess contributions apportioned to any highly compensated employee must not exceed the amount of elective contributions actually contributed to the plan undergoing the correction. If the corrective distribution made to such highly compensated employee is not sufficient to fully correct the ADP failure, then the plan must make a corrective distribution to the highly compensated employee with the next highest dollar amount of total elective contributions in the same manner. The plan must continue to make corrective distributions until the excess contributions are completely apportioned.

This correction method is applied independently to each 401(k) plan. If two or more 401(k) plans fail to satisfy the ADP test, the actual deferral ratios of highly compensated employees who have received corrective distributions under the other plans are not recalculated after correction in the first plan.

The proposed regulations include a similar provision for correcting ADP failures through corrective distributions.