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July 30, 2003

PROPOSED IRS RULES FOR 401(k)/(m) PLANS – WHAT THEY WOULD CHANGE

A. GENERAL RULES FOR 401(k) DEFERRALS

	Existing Guidance	Proposed Regulation
Reference to salary reduction agreement eliminated	In the definition of a cash or deferred arrangement ("CODA"), the regulations provide that a CODA includes a salary reduction agreement between an employee and the employer.	The proposed regulations would not change the basic definition of a CODA, but would eliminate the reference to a salary reduction agreement. The preamble indicates that a salary reduction agreement can still qualify as a CODA, but the specific reference to a salary reduction agreement is viewed as unnecessary.
Automatic enrollment ("negative" deferral elections)	The rules regarding automatic enrollment in 401(k) plans, which allow a plan to provide for an automatic salary deferral election for an employee unless the employee affirmatively elects otherwise, are contained in Revenue Ruling 2000-8.	The proposed regulations would permit plans to provide for negative deferral elections. The proposed regulations do not include the employee notice requirements described in Rev. Rul. 2000-8. However, the proposed regulations would add employee notice standards to be generally applicable to all 401(k) plans (see below). Also, the preamble to the proposed regulations notes (as does Rev. Rul. 2000-8) that a negative deferral election is not considered a participant investment election for purposes of the ERISA section 404(c) rules. The DOL takes the position that the plan fiduciary retains responsibility over the investment of contributions until the participant provides investment direction.
Employee deferral election process	The existing regulations do not provide specific rules for salary deferral elections.	The proposed regulations would require the plan to provide employees with an effective opportunity to make (or change) a cash or deferred election at least once during each plan year. Whether an employee has an effective opportunity would be determined based on all the relevant facts and circumstances, including

	Existing Guidance	Proposed Regulation
		notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.
Contributions may not precede election	Some employers pre-fund future elective contributions and matching contributions in order to accelerate tax deductions. In Notice 2002-48, the IRS indicated that contributions before the end of the employer's tax year made in anticipation of future elective or matching contribution obligations could be deducted in the year of contribution.	The proposed regulations would provide that a contribution will be treated as CODA only if it is made after the employee's deferral election is made. Also, the contribution would have to be made after the employee performs the services with respect to which the contribution is made (or after the date the compensation would have been paid, if earlier). Under these rules, an employer could not pre-fund future employee deferrals. Any pre-funding would be treated as an employer profit-sharing contribution and could not be used to offset amounts required to be contributed on account of future employee salary deferrals. Similar rules would apply with respect to the pre-funding of matching contributions. Thus, employers would not be able to accelerate the timing of their deduction by pre-funding elective deferral and matching contributions. Similarly, any such pre-funded contributions could not be used to satisfy any plan requirement to provide elective contributions or matching contributions.

B. DISTRIBUTION RULES

	Existing Guidance	Proposed Regulation
General distribution restrictions – change in status to leased employee	Because of the repeal (in EGTRRA) of the "same desk" rule, distributions of amounts attributable to 401(k) contributions are now available upon an employee's "severance from employment," which generally includes any termination of the common-law employee relationship with the employer maintaining the plan.	The repeal of the "same desk" rule and related statutory changes to the 401(k) distribution limitations (and published IRS guidance regarding these changes) are reflected in the proposed regulations. In the preamble, the Service requests comments on whether a change in status from an employee to a leased employee should be treated as a severance of employment that would permit a distribution to the participant.
Hardship distributions	The existing regulations contain detailed rules regarding hardship distributions, including safe harbors.	The hardship distribution rules would be revised to reflect the change made by EGTRRA to shorten, from 12 months to 6 months, the required contribution suspension period following a safe harbor hardship distribution. (The proposed regulations also reflect the related elimination by the Service, in Notice 2002-4, of the deferral limitation that had applied in the year after the suspension period). In addition, the hardship rules would be reorganized and revised to clarify the following points: • Each of the two basic requirements (*i.e.*, immediate and heavy financial need, and distribution is necessary to satisfy need) have separate safe harbor rules that the plan may separately elect to apply. • The employee representation that a distribution is necessary to satisfy the need must provide that the need cannot reasonably be relieved from other sources, including by any available plan distribution or loan. The proposed regulations in this regard are virtually identical to the existing regulations. Some have interpreted the existing regulations to allow a hardship distribution if the entire hardship cannot be relieved entirely by one of the listed sources in the regulations. However, a parenthetical statement in the Preamble

	Existing Guidance	Proposed Regulation
		suggests that other sources must be utilized to help relieve the hardship before a hardship distribution is permissible, even if the other sources cannot relieve the entire hardship need. The one exception is a commercial loan, which must be used only if the loan could entirely satisfy the hardship need. • For purposes of applying the rules regarding the availability of loans and distributions from other plans to satisfy the financial need requirements, "other plans" include all qualified and nonqualified plans of deferred compensation maintained by the employer, including a cash or deferred arrangement that is part of a cafeteria plan (but not including mandatory employee contributions under a defined benefit plan or contributions under a health or welfare benefit plan).
Distributions following plan termination	Distributions on account of plan termination are not permitted if the employer maintains a successor defined contribution plan. A successor plan does not include an ESOP or SEP.	The proposed regulations would provide that a successor defined contribution plan (called an "alternative" defined contribution plan in the proposed regulations) does not include a SIMPLE IRA, a 403(b) plan, or a 457 plan. Thus, plan termination distributions would not be prohibited by maintenance of such a plan (nor by maintenance of an ESOP or SEP).
Plan-to-plan transfers and distribution restrictions	The 401(k) distribution limitations continue to apply under a plan that receives a plan-to-plan transfer (not a rollover contribution) of elective contributions.	The proposed regulations would clarify that qualified nonelective contributions and qualified matching contributions must remain subject to the 401(k) distribution limitations following a plan-to-plan transfer. The new rules would prohibit a plan from transferring accounts (except in the case of a direct rollover) to a plan that does not provide that the transferred amounts will remain subject to these limitations. The transferor plan would satisfy this requirement if it reasonably concludes that the transferee plan maintains the distribution limitations (under rules comparable to the rules for accepting rollover contributions).

C. NONDISCRIMINATION TESTING

	Existing Guidance	Proposed Regulations
Minimum coverage testing – Disaggregation of plans with different testing methodologies	The existing guidance does not address whether plans that use different methodologies to satisfy sections 401(k) and 401(m) – safe harbor or non-safe harbor plans – can be aggregated for minimum coverage testing.	The proposed regulations would provide that all 401(k)/401(m) plans that are aggregated for purposes of 410(b), must employ the same testing method for ADP/ACP purposes. For example, a plan that satisfies the ADP test by testing may not be aggregated with a plan that uses the ADP safe harbor.
ADP/ACP testing – Incorporation by reference	The existing regulations allow plans to incorporate the ADP and ACP testing provisions by reference. However, if there are optional choices that may be applied, the plan must specify which option will be applied. For example, the plan must specify whether current year or prior year testing will be used.	The proposed regulations would not change the existing regulations in this regard. However, they would clarify that a plan may not include provisions relevant to both ADP/ACP testing and the ADP/ACP safe harbor, and provide that ADP/ACP testing will be performed only if the plan does not meet the safe harbor.
ADP/ACP testing – Aggregation of ESOP and non-ESOP portions of a plan for testing purposes	In general, all CODAs included in a plan are aggregated for purposes of applying the ADP/ACP tests. However, the mandatory disaggregation rules of Reg. § 1.410(b)-7(c) apply. These regulations provide for the mandatory disaggregation of an ESOP and non-ESOP portion of a plan, any 401(k) or 401(m) plan that includes both an ESOP and non-ESOP portion must perform separate ADP and ACP tests for the ESOP and non-ESOP portions of the plan.	The proposed regulations would retain the general aggregation rules. However, noting the increased use of ESOPs as an investment fund in 401(k) plans, and the increased expense and administrative difficulty that the disaggregation rule creates for these plans, the proposed regulations would eliminate the mandatory disaggregation of ESOPs and non-ESOPs for ADP/ACP testing. This exception from the mandatory ESOP disaggregation rule would not apply for other nondiscrimination testing purposes, including the 410(b) coverage test.
ADP/ACP testing – Aggregation of contributions of HCEs	The deferral ratio of any HCE who is eligible to participate in 2 or more CODAs of the same employer is calculated by aggregating his or her elective deferrals under all CODAs that may be aggregated under 410(b). Where the elective deferrals are made under plans that have different plan years, the elective deferrals made under all plans that end with or within a single calendar year are aggregated. This methodology for aggregating elective deferrals for plans	The proposed regulations would retain the general rule regarding the aggregation of elective deferrals of any HCE. However, the HCE aggregation rule would be modified to reflect the new rule that ESOPs may be aggregated with non-ESOPs. In addition, the proposed regulations would address the problem of aggregating plans with different plan years by providing that the deferral ratio for an HCE is determined by aggregating his or her elective deferrals made

	Existing Guidance	Proposed Regulations
	that have different plan years can result in elective deferrals for more than a 12-month period being taken into account in the ADP testing. Aggregation is also required for purposes of ACP testing.	within the plan year of the plan being tested. In addition, in determining the HCE's compensation, only compensation paid during the plan year of the plan being tested, using the definition of compensation in that plan, would be included. The result is that the deferral ratio of an HCE who participates in multiple CODAs would be based on 12 months of elective contributions and 12 months of compensation. Finally, the proposed regulations would clarify that elective deferrals of HCEs under plans using inconsistent testing methods can be aggregated. These rules also would apply for purposes of ACP testing.
ADP/ACP testing – QNECs	Currently, plans may meet the ADP/ACP tests by making Qualified Nonelective Contributions ("QNECs") to the plan using the "bottom-up leveling" method whereby QNECs are made on behalf of employees with the lowest level of compensation, to the extent necessary to satisfy the tests. This technique allows plans to meet the ADP/ACP test with the smallest employer contribution.	The proposed regulations would add a new requirement for QNECs, designed to limit the use of "targeted" QNECs, i.e., QNECs that are targeted to a small number of employees with low compensation to minimize the nonelective contribution necessary to satisfy the ADP/ACP test. The proposed regulations would restrict the use of QNECs only to the extent they exceed a participant's compensation multiplied by the greater of (i) 5% or (ii) two times the plan's representative contribution rate. In addition, a plan would be treated as providing impermissible targeted QNECs if less than half of all NHCEs receive QNECs of more than 5% of compensation. The plan's representative contribution rate would be defined as the lowest contribution rate among a group of NHCEs that is half of all the eligible NHCEs under the arrangement (or, if greater, the lowest contribution rate among all eligible NHCEs under the arrangement who are employed on the last day of the year, if greater). A participant's contribution rate is the sum of the QMACs and QNECs taken into account under the ADP test for the plan year divided by the employee's

	Existing Guidance	Proposed Regulations
		compensation for the same period. (Any QNEC that is taken into account in determining the representative contribution rate for ADP test purposes cannot be taken into account in determining the representative rate for ACP test purposes.) The proposed regulations would provide essentially the same restriction on targeted QNECs for ACP test purposes. The difference would be that the relevant contribution rate would be the sum of the matching contributions and QNECs made on behalf of a participant divided by the participant's compensation. Because QNECs that do not exceed 5% are not subject to the limits on targeted QNECs under either the ADP test or the ACP test, a plan may take into account up to 10% in QNECs without regard to the restrictions on QNECs: 5% in ADP testing and 5% in ACP testing.
ADP testing – Limit on QMACs	Currently, plans may meet the ADP tests by making Qualified Matching Contributions ("QMACs") to the plan using the "bottom-up leveling" method, whereby QMACs are made on behalf of employees with the lowest level of compensation to the extent necessary to satisfy the tests.	To prevent an employer from using "targeted QMACs," the proposed regulations would provide that matching contributions may not be taken into account in the ADP test to the extent the matching rate for the contribution exceeds the greater of (i) 100% or (ii) 2 times the representative matching rate. The plan's representative matching rate would be the lowest matching rate for all eligible NHCEs among a group of NHCEs that consists of half of all eligible NHCEs who make elective deferrals or employee contributions (or, if greater, the lowest matching rate for all eligible NHCEs in the plan who are employed on the last day of the plan year and who make elective deferrals or employee contributions). The matching rate would be the amount of matching contributions divided by elective deferrals and employee contributions being matched.
ADP/ACP testing – Timing of QNEC/QMAC	Under the existing guidance, the timing rules applicable to contributions of QNECs/QMACs used to satisfy the ADP	The proposed regulations would clarify that, with respect to a plan that uses prior year testing, QNECs and QMACs must be

	Existing Guidance	Proposed Regulations
contributions	test using prior year testing are unclear.	contributed to the plan no later than the end of the plan year being tested (*i.e.*, the end of the 12-month period immediately following the year for which they are allocated).
ADP/ACP testing – Double counting	The existing guidance includes a prohibition on "double counting" QNECs. Generally, QNECs used (i) in an ADP or ACP test, (ii) to satisfy the safe harbor under section 401(k), or (iii) under a SIMPLE 401(k) plan cannot be used again to demonstrate compliance with another test under Code sections 401(k)(3) or 401(m)(2).	The proposed regulations would retain the prohibition against double counting in the existing guidance. However, they would explicitly exempt from the prohibition elective contributions or matching contributions that are moved between the ADP and ACP tests. In addition, the proposed regulations would provide an exception from double counting for a new plan that elects prior year testing and, for its first plan year, elects to use the ADP for NHCEs during that first year (instead of the 3% method). In this case, the prohibition on double counting QNECs would not apply to the testing for the second plan year.
ACP test – Use of elective deferrals	Elective deferrals may be used to help a plan pass the ACP test, provided they met certain requirements._	The proposed regulations would add an additional restriction on the use of elective deferrals to pass the ACP test: elective deferrals under a safe harbor plan (or other plan that is not subject to ADP testing) could not be taken into account for ACP test purposes.
ADP/ACP testing – Prior year testing	The existing guidance is unclear about whether the ADP and ACP tests must be consistent with respect to the election of prior year or current year testing.	The proposed regulations would provide that plans need not be consistent with respect to ADP and ACP testing. However, if the methodologies are inconsistent, then the following corrective procedures would be prohibited: (i) elective deferrals could not be recharacterized as after-tax contributions; (ii) elective deferrals could not be taken into account under the ACP test; and (iii) QMACs could not be taken into account under the ADP test.
ACP/ADP testing – Impact of plan coverage changes on use of prior year testing	The existing guidance provides that, where there has been a plan coverage change affecting more than 10% of the NHCEs covered by a plan, the ADP and ACP for NHCEs for the prior year is the weighted average of the ADPs and ACPs of the NHCEs in the plans in which the	The proposed regulations would incorporate the existing guidance. They also would clarify that a plan coverage change includes changes in the group of eligible employees under a plan resulting from the establishment or amendment of a plan, a plan merger or spin-off or a change in the way plans are combined or separated

	Existing Guidance	Proposed Regulations
	NHCEs participated in the prior year.	under the section 410(b) rules, as well as a reclassification of a substantial group of employees that has the same effect as amending the plan. They provide that a plan that merely experiences a spin-off is not required to recalculate the ADP for the NHCEs.
ADP/ACP correction – Correction of excess contributions where HCE participates in multiple 401(k) or 401(m) plans	The existing regulations provide that a plan's failure to meet the ADP test can be corrected by distributing or recharacterizing excess contributions. The total amount of excess deferrals for all HCEs is based on lowering the deferral ratios of HCEs to the point where the ADP test is met. Then the excess amount is apportioned among the HCEs by assigning the excess to those HCEs with the greatest dollar amount of contributions. A corresponding rule applies for ACP test purposes.	The proposed regulations would adopt the same manner of correcting a plan's failure to meet the ADP test. In addition, they would provide a special rule for correction in the case of an HCE who participates in multiple plans. In that case, the proposed regulations provide that, for purposes of determining which HCE will be apportioned a share of the total excess contributions to be distributed or recharacterized, all elective deferrals of an HCE are aggregated and the HCE with the highest dollar amount of contributions will be apportioned excess contributions first. However, only elective deferrals made to the plan being corrected – rather than elective deferrals under all plans in the aggregate – may be distributed. If correction is needed in more than one plan, the deferral ratios of HCEs who have received corrective distributions from one plan are not recalculated. A similar rule would apply for ACP test purposes.
ADP/ACP correction – Net income associated with excess contributions	Under the existing guidance, income on any excess contributions that are distributed must be distributed as well. However, income attributable to the "gap period" can be disregarded. The gap period is the period after the end of the plan year and before the date of distribution.	The proposed regulations would provide that income on excess contributions must be distributed along with the excess contributions, including income attributed to the gap period. In general, the proposed regulations would provide the same methodologies to determine the gap period income as the current regulations.
ADP/ACP correction – Corrective distributions in context of plan termination	The existing guidance is unclear about how to address an ADP failure where a plan is terminated and accounts distributed before the ADP test reveals that corrective distributions are necessary.	The proposed regulations would provide a special rule applicable to corrective distributions from a plan that has been terminated, and accounts distributed, before the results of the ADP test are known. In that case, the distributions would be deemed to

	Existing Guidance	Proposed Regulations
		have been corrective distributions of excess contributions to the extent that a corrective distribution would otherwise have been required. A similar rule would apply for purposes of ACP test purposes.
ADP/ACP correction – Recharacteriza-tion of excess contributions	The existing guidance provides for different tax treatment of elective deferrals that are distributed and those that are recharacterized.	The proposed regulations would provide that the tax treatment of amounts that are recharacterized would be the same as the treatment of amounts that are distributed.

D. ADP/ACP SAFE HARBOR ISSUES

	Existing Guidance	Proposed Regulations
ADP safe harbor – Aggregation of contributions	The existing guidance provides that in order to satisfy the ADP safe-harbor using matching contributions, the rate of matching contributions for any elective deferral of any HCE cannot exceed the rate of matching contributions that would apply to any NHCE with the same rate of elective contributions. This determination is made in accordance with the general rule whereby contributions of HCEs who participate under more than one CODA are aggregated.	The proposed regulations would not require that CODAs be aggregated for purposes of satisfying the requirement that the rate of matching contributions of any HCE must not exceed the rate of any NHCE with the same rate of elective deferrals. Accordingly, the rate of matching contributions of any HCE would be based only on matching contributions associated with elective deferrals under the safe harbor plan.
ADP safe harbor – Suspension of contributions in association with hardship withdrawal	The existing guidance provides that elective deferrals and after-tax contributions may be suspended after a participant takes a hardship distribution from a safe harbor plan that matches both elective deferrals and after-tax contributions.	The proposed regulations would permit a participant who takes a hardship distribution from a safe harbor plan to continue making after-tax contributions that are matched without regard to the suspension of elective deferral contributions.
ADP safe harbor – Catch-up contributions	The existing guidance does not address whether catch-up contributions must be matched in a safe harbor plan.	The proposed regulations do not include any exception to the requirements for safe harbor matching contributions with respect to catch-up contributions. Treasury and IRS request comments on (i) the specific circumstances under which elective deferrals by a NHCE to a safe harbor plan would be less than the amount required to be matched (e.g., less than 5% of safe harbor compensation), but would be treated by the plan as catch-up contributions, and (ii) the extent to which a safe harbor plan should be required to match catch-up contributions under such circumstances.
ADP safe harbor – Electronic transmission of safe harbor notice requirement	ADP safe harbor plans must provide participants with a notice informing them of the safe-harbor contribution. Existing guidance addresses the use of electronic media to satisfy the notice requirement (Notice 2000-3, Q&A 7).	The proposed regulations do not address the use of electronic notices for purposes of the safe-harbor notice requirement. The Preamble states that guidance addressing the use of electronic communications generally will be issued separately. Until this guidance is issued, plans may continue to rely on Notice 2000-3, Q&A-7.

	Existing Guidance	**Proposed Regulations**
ADP safe harbor – Plan must be in place for 12-month plan year	Under the existing guidance, a safe harbor plan must be maintained for a full 12-month plan year. However, a short plan year is permitted in the first plan year, provided the first plan year is at least 3 months.	The proposed regulations would allow a short plan year in additional circumstances: • When the plan terminated, if the plan termination was in connection with a merger or acquisition involving the employer, or the employer incurred a substantial business hardship comparable to a substantial business hardship described in section 412(d); • When the plan terminated, provided the employer made safe harbor contributions for the short year, employees were provided notice of the change, and the plan passed the ADP test; and • Where the short plan year was preceded and followed by 12-month plan years during which the plan was a safe harbor plan.
ACP safe harbor – HCEs receiving matching contributions under more than one plan	Under existing guidance, matching contributions made on behalf of an HCE who is eligible to participate in more than one plan must be aggregated for testing purposes, even if the plan is an ACP safe harbor plan.	The proposed regulations would generally retain the aggregation rules. However, they would provide that a plan would not fail to satisfy the ACP safe harbor if an HCE participated in more than one plan with matching contributions, provided that the HCE did not participate simultaneously under the plans, and the participant's compensation was based only on the portion of the year during which he or she participated in the safe harbor plan. Thus, an HCE could transfer from a plan with a more generous matching schedule to a safe harbor plan without causing the safe harbor plan to fail the safe harbor requirements.

E. OTHER ISSUES

	Existing Guidance	Proposed Regulation
Contingent benefit restrictions	A CODA does not satisfy the 401(k) rules if the provision of other benefits (other than matching contributions) are conditioned upon the employee's election to make (or not to make) elective contributions.	The proposed regulations would specify that a benefit (such as a plan loan) that results in payroll withholding (*e.g.*, periodic plan loan repayments) that reduces the compensation subject to a deferral election would not violate the contingent benefit restrictions.
Rules applicable to partnerships and sole proprietors	The existing regulations specifically address the 401(k) plan rules for partnerships, but do not specifically address sole proprietors.	The proposed regulations would extend the partnership rules to sole proprietors.
SIMPLE 401(k) plans	Rules for SIMPLE 401(k) plans are contained in Code section 401(k)(11) and, generally, in Revenue Procedure 97-9.	The proposed regulations would provide a new section to reflect the rules for SIMPLE 401(k) plans. These proposed rules are based on the positions reflected in the model amendments provided in Revenue Procedure 97-9.