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MEMORANDUM TO CLIENTS

January 28, 2005

Re: Final Comprehensive IRS Rules For 401(k)/(m) Plans

On December 29, 2004, the IRS published final comprehensive regulations under Code sections 401(k) and 401(m). 69 Fed. Reg. 78143. These new 401(k)/(m) regulations incorporate many of the provisions in the existing regulations, which were first published in 1991, and amended in 1994. In addition, they incorporate the numerous statutory changes that have been made to 401(k)/(m) plans after 1994, as well as IRS guidance related to the changes.

The regulations are effective for plan years beginning on or after January 1, 2006. However, plan sponsors are permitted to apply the regulations to any plan year that ends after December 29, 2004, provided the plan applies *all* the rules in the final regulations for that plan year and all subsequent plan years. Thus, for example, an employer that would like to take advantage for the 2004 plan year of the ability to aggregate ESOP and non-ESOP portions of a plan for testing purposes will have to consider whether it can apply all the other testing rules as well.

A. Brief Summary of Key Changes

The final regulations include numerous changes that were introduced in the proposed regulations, which were issued on July 17, 2003. Even the more significant changes are quite technical, including those that –

- restrict the use of "targeted" QNECs and QMACs, such as QNECs allocated under the "bottom-up leveling" method, to satisfy the ADP/ACP tests;
- allow the aggregation of ESOPs and non-ESOPs for ADP/ACP testing purposes, making it easier for companies to take advantage of the ESOP dividend deduction;
- prohibit employers from pre-funding 401(k) deferrals and matching contributions to accelerate tax deductions (although the final regulations permit pre-funding for bona fide administrative considerations);

- add funeral expenses and expenses relating to the repair of damage to an employee's principal residence to the list of permissible safe harbor hardship distributions;
- disregard the recent narrowing of the definition of "dependent" in Code section 152 by the Working Families Tax Relief Act of 2004 for purposes of hardship distributions;
- expand the class of children whose medical expenses can result in a hardship distribution to include a non-custodial child;
- require that a plan may only make a plan-to-plan transfer of 401(k) accounts if it reasonably concludes that the accepting plan will continue to apply the 401(k) distribution restrictions to the transferred accounts;
- require the distribution of "gap period" earnings on excess contributions, although the final regulations provide that a plan may calculate earnings up to seven days before the date the excess contributions are distributed;
- extend the 401(k) rules for partnerships to sole proprietors;
- require that 401(k) contributions, which are nonforfeitable, generally must be taken into account for purposes of the section 411(a) vesting and service-crediting rules, such as whether 0% vested employer contributions can be deemed distributed and forfeited upon a participant's termination of employment, and whether a rehired participant's pre-break service may be disregarded upon his reemployment under the rule of parity;
- clarify that a change in status from employee to leased employee is not an event permitting distributions;
- clarify that a 401(k) plan utilizing the "early participation" rule under section 410(b)(4)(B) may rely on the ADP safe harbor solely for the portion of the plan that benefits participants with at least one year of service.

The final regulations are also notable because they do not –

- provide a general exception for flat dollar QNECs and QMACs, as requested by several commentators;
- drop the broad "anti-abuse" provision relating to testing methods, despite numerous requests by commentators;
- provide an exception for catch-up contributions that are recharacterized as matching contributions in the application of the ACP safe harbor, which requires that the rate of matching contributions must be the same for all participants; or
- provide much guidance on testing issues that arise in the context of mergers and acquisitions.

A chart listing all material changes made by the final regulations to existing guidance is enclosed.

B. Plan Amendments

Although the regulations permit some provisions to be incorporated by reference, it is likely that most 401(k) plans will have to be amended to reflect the new regulations. For example, many plans utilizing the ADP safe harbor include the non-safe harbor testing provisions, but limit their application to plan years that the employer decides not to rely on the safe harbor. This is no longer permissible – plans must expressly state whether they utilize safe harbor or non-safe harbor testing. In addition, plan documents will have to reflect the various testing options, as well as the fact that elective deferral contributions are taken into account in determining whether a participant is a "nonvested" participant under the rule of parity. It is also likely that employers will want to incorporate the various changes to the safe harbor hardship distribution provisions.

The IRS has not stated whether it intends to publish a model amendment, or whether plans must be amended before the regulations are implemented, *i.e.*, by the end of the 2005 plan year. However, in light of the fact that the new regulations may be applied for years ending after December 29, 2004, the IRS implies that operational compliance is sufficient.

Enclosure