



Electronic Dispatch

Employee Benefits Law Action Memo

March 2005

[Go to BS&K Employee Benefits Home Page](#)

IRS ISSUES FINAL REGULATIONS FOR 401(k) PLANS

The Internal Revenue Service ("IRS") regulations regarding salary deferral contributions under Section 401(k) of the Internal Revenue Code ("Code") and matching contributions under Section 401(m) of the Code were last amended in 1994. Since that time, there have been significant statutory changes to Code Sections 401(k) and 401(m), as well as many IRS rulings and notices, that have resulted in portions of the 1994 regulations being out-of-date and inconsistent with other guidance. On December 29, 2004, the IRS issued updated final regulations under Code Sections 401(k) and 401(m). The IRS has indicated that the final regulations are intended to "clarify and simplify" the rules applicable to 401(k) plans. While the new regulations certainly clarify a number of issues, whether or not the rules have been simplified is open to debate. In any event, the new regulations consolidate many pieces of prior guidance and make certain changes that plan sponsors should take into consideration. Summarized below are a few of the more significant changes made by the final regulations.

Effective Date

The new regulations are effective for plan years beginning on or after January 1, 2006. However, plan sponsors may elect to apply the regulations for plan years ending after December 29, 2004 (e.g., the 2004 and 2005 plan years, for calendar year plans), provided that the plan sponsor complies with all of the provisions of the final regulations for the entire plan year and subsequent plan years.

New Financial Hardship Criteria

Many 401(k) plans provide that participants may elect an in-service withdrawal of salary deferral contributions in the event of the occurrence of an immediate and heavy financial need. The 1994 regulations provided a list of four events that would be deemed to constitute financial hardships. The final regulations expand this list to include: (a) payments for burial or funeral expenses for the participant's deceased spouse, parents, children or dependents; and (b) expenses for the repair of damage to the participant's principal residence that would qualify as deductible casualty expenses.

ADP/ACP Testing Issues

The final regulations make a number of changes and clarifications regarding the application of the special nondiscrimination tests applicable to salary deferral contributions, matching contributions, and employee after-tax contributions (referred to as the actual deferral percentage ("ADP") test and the actual contribution percentage ("ACP") test). Some of these changes include:

Targeted QNECs

One of the options available for a plan that fails the ADP test for a plan year is for the employer to make a special, fully vested employer contribution, called a qualified non-elective contribution or "QNEC," to certain participants. Some employers have allocated QNECs disproportionately to the lower-paid nonhighly compensated employees, as this method has the greatest impact on the ADP test at the lowest cost. This is sometimes referred to as "bottom-up leveling" or "targeted" QNECs. The final regulations significantly restrict an employer's ability to use such methods. Under the new rules, QNECs greater than 5% of compensation may be taken into account under the ADP test only if the QNEC does not exceed two times the plan's "representative contribution rate," as defined under the regulations. Similar restrictions apply in connection with the use of qualified matching contributions ("QMACs").

Testing Methods

The final regulations confirm that the plan document must specify the method by which the plan will satisfy the ADP and ACP tests, whether by the use of the "current year" or "prior year" testing methods, or by satisfying one of the "safe harbors" pursuant to which the plan provides certain fully vested nonelective or matching contributions. The regulations provide that a plan may *not* provide for the use of a safe harbor, but also



provide that, in the event that the plan fails to satisfy one of the requirements in connection with the safe harbor, the plan will instead perform the ADP and/or ACP test. In addition, the final regulations include an anti-abuse rule designed to prevent employers from making repeated changes in a plan's testing method to produce results that are favorable to highly compensated employees.

Safe Harbor Rules

As noted above, the "safe harbor" rules serve as an alternative to performing the ADP and ACP tests. The final regulations, following prior guidance issued by the IRS regarding safe harbor plans, continue to limit the ability of a plan sponsor to satisfy the safe harbor rules for less than a full 12-month plan year. However, the final regulations add an exception for 401(k) plans that terminate in connection with a substantial business hardship or a merger or acquisition. A safe harbor plan also may terminate mid-plan year, resulting in a short plan year, if the plan satisfies the safe harbor requirement through the termination date, provides participants with 30-days notice of the termination, and passes the ADP and ACP tests for the year of termination.

Pre-Funding Prohibited

In prior guidance, the IRS indicated that an employer could "pre-fund" salary deferral contributions and matching contributions to accelerate the employer's tax deduction. The final regulations now prohibit this practice. Under the final regulations, contributions generally may be made only after the employee performs the services to which the contributions relate and after the deferral election has been made. As a limited exception, early contributions may be made occasionally for "bona fide administrative considerations" and not for the principal purpose of accelerating the employer's deduction. For example, an early contribution might be permitted if the bookkeeper responsible for transmitting the contributions will be on vacation when the contributions would normally be made.

Distributions to Leased Employees

The final regulations reflect the elimination of the "same desk" rule by the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"). Under EGTRRA and the final regulations, a participant is entitled to a distribution from a 401(k) plan upon the participant's "severance from employment." The final regulations clarify that a participant's change in status from a common-law employee to a leased employee is not a severance from employment that would entitle the participant to a distribution from the plan.

Recommended Actions

Plan sponsors should begin to review their plans to determine what changes may be required to comply with the requirements of the final regulations. Plan sponsors should also consider whether or not to apply the new regulations prior to their mandatory effective date of the first day of the first plan year beginning on or after January 1, 2006. Plan amendments will eventually be required to reflect some of the changes made by the final regulations. However, the IRS has not yet issued guidance on the timing of such amendments.

If you have any questions, please contact any of the following members of our Employee Benefits Law Practice Group:

In Central New York, call 315-218-8000 or e-mail:

Lisa A. Christensen	lchristensen@bsk.com	Stephen C. Daley	sdaley@bsk.com
John C. Godsoe	jgodsoe@bsk.com	Brian K. Haynes	bhaynes@bsk.com
Richard D. Hole	rhole@bsk.com	Ted Lewkowicz	tlewkowicz@bsk.com
Aaron M. Pierce	apierce@bsk.com		

In the Capital District, call 518-533-3000 or e-mail:

Joanmarie M. Dowling	jdowling@bsk.com	Amelia M. Klein	aklein@bsk.com
----------------------	------------------	-----------------	----------------

In Western New York, call 716-566-2800 or e-mail:

Darcie A. Falsioni	dfalsioni@bsk.com
--------------------	-------------------

In New York City and on Long Island, please contact any of the following members of our Labor and Employment Law Department:

On Long Island, call 516-267-6300 or e-mail:

Terry O'Neil	toneil@bsk.com
--------------	----------------

In New York City, call 646-253-2300 or e-mail:

Louis P. DiLorenzo	ldilorenzo@bsk.com
--------------------	--------------------