

**THE 401(K) AND (M) REGULATIONS
ENTER THE 21ST CENTURY**

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At the end of 2004, the Internal Revenue Service (IRS) issued final regulations on salary deferrals and matching and post-tax employee contributions under Sections 401(k) and (m) of the Internal Revenue Code (the Code), the first significant update of these rules in almost a decade. The final regulations principally follow the proposed regulations issued by the IRS in 2003 but also provide certain clarifications, as well as some new guidance. In essence, these final regulations update the prior regulations to reflect statutory changes and consolidate into a single source guidance previously issued by the IRS.

Background

Comprehensive regulations under Sections 401(k) and (m) of the Code were finalized in 1991 and amended in 1994. These regulations had not been updated since 1994, and therefore did not reflect any of the subsequent changes in the Code or corresponding guidance issued by the IRS. Among the changes were the introduction of safe harbor alternatives to the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests, catch-up contributions for older participants, increases in salary deferral limits and accelerated vesting of matching contributions.

Final 401(k) and 401(m) Regulations

While the final regulations retain much of the substance of the proposed regulations issued in July 2003, certain important changes and clarifications were made. The following summary describes certain of these changes and clarifications.

Contribution Rules

- **Roth Contributions.** The final regulations expand the definition of a cash or deferred arrangement (CODA) to include an arrangement under which participants may make after-tax designated Roth contributions. Accordingly, for most purposes Roth contributions are not treated as after-tax contributions, but rather as pre-tax elective deferrals. The final regulations also provide that the right to make Roth contributions under a 401(k) plan is a right or feature that is subject to nondiscrimination testing under Section 401(a)(4) of the Code. Except for these two items, the final regulations do not provide any additional guidance on Roth contributions. The IRS more fully addresses Roth contributions, however, in proposed regulations that were issued separately on March 2, 2005.
- **Deferral Elections.** The final regulations impose the new requirement that a plan, in order to be a qualified CODA, must provide employees with an effective opportunity to make or change a deferral election at least once during each plan year. Whether an employee has been provided an effective opportunity is determined based on all relevant facts and circumstances, including the adequacy

of notice of the availability of the election, the period of time before cash becomes available during which an election may be made, and any other conditions on elections. This is generally not an issue for most employers, since most 401(k) plans allow participants to make or change their deferral elections at least on a quarterly basis.

- Automatic Enrollment. Consistent with earlier IRS guidance, the final regulations permit an employer to enroll all employees automatically in the employer's 401(k) plan and to set a default deferral if no affirmative election is made by the employee (i.e., the employee fails to opt out by not returning the deferral election form). While the final regulations do not specify a requisite safe harbor percentage, they do require that an employee have the opportunity to elect to receive cash instead of the default deferral. Accordingly, to comply with the final regulations an employer must inform its employees of the automatic enrollment prior to the date employees are first eligible to participate in the plan and allow employees to cease automatic deferrals at any time. The protection under Section 404(c) of ERISA, however, will not apply to any default investments selected by the employer in the case of an employee who does not designate his or her specific investment choices. As a result, there are ERISA fiduciary implications that an employer must consider with respect to default investments on automatic enrollments.
- Prefunded Contributions. The final regulations retain the proposed rule that elective deferral and matching contributions generally cannot be funded before an employee has earned the underlying compensation. In other words, an employer may not prefund contributions to accelerate deductions as permitted under Notice 2002-48, and employer contributions made under the facts in Notice 2002-48 will neither be taken into account under the ACP test nor satisfy any plan requirement to provide matching contributions. Exceptions to this limitation occur when: (i) the prefunding is for bona fide administrative considerations (e.g., the temporary absence of the bookkeeper responsible for transmitting contributions) and is not made early with the principal purpose of accelerating deductions, (ii) matching contributions are made from forfeitures, or (iii) matching allocations of employer securities are released from encumbrance under a securities acquisition loan in a leveraged employee stock ownership plan (ESOP), provided the contributions are due under the loan terms and not made early with the principal purpose of accelerating deductions.

Nondiscrimination Rules

- Restrictions on Targeted QNECs under the ADP/ACP Tests. The final regulations generally retain the rules in the proposed regulations permitting employers to make qualified nonelective contributions (QNECs) to help their plans pass the ADP test, but add a new restriction designed to limit so-called "bottom-up" QNECs. Under the final regulations a plan can count a QNEC greater than 5% of compensation only if the QNEC does not exceed two times the

plan's "representative contribution rate." The final regulations define a plan's representative contribution rate as the lowest applicable contribution rate of any eligible non-highly compensated employee (NHCE) among a group of eligible NHCEs that consists of half of all eligible NHCEs for the plan year (or, if greater, the lowest applicable contribution rate of any eligible NHCE in the group of all eligible NHCEs for the plan year who are employed by the employer on the last day of the plan year). Thus, an employer is now prohibited from making contributions to a few NHCEs with low compensation levels for the year, in amounts that are relatively large individually but relatively small in the aggregate, in order to meet the ADP test. The final regulations also provide an exception to this restriction for QNECs made in connection with an employer's obligation to pay a prevailing wage under the Davis-Bacon Act or similar legislation by permitting a QNEC of up to 10% of compensation to be taken into account under the ADP test in such a case.

The final regulations provide corresponding restrictions on QNECs taken into account for ACP testing. The same QNECs may not be taken into account, however, for both the ADP and ACP tests. Since QNECs that do not exceed 5% of compensation are not subject to the limits on targeted QNECs under either the ADP or the ACP test, employers may take into account up to 10% in QNECs for eligible NHCEs (i.e., 5% in ADP testing and 5% in ACP testing) without regard to the additional restrictions.

- Restrictions on QMACs under the ACP Test. The proposed regulations provided a basic rule designed to prevent an employer from using targeted qualified matching contributions (QMACs) for NHCEs to circumvent the limitation on targeted QNECs. Under the basic rule, an employer may not take a QMAC into account under the ACP test to the extent the matching rate for the contribution exceeds the greater of 100% of the NHCE's contribution or two times the plan's "representative matching rate." The proposed regulations defined the plan's representative matching rate as the lowest applicable matching rate for any eligible NHCE among a group of eligible NHCEs that consists of half of all eligible NHCEs in the plan for the plan year who make elective deferrals for the plan year (or, if greater, the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year and who make elective deferrals for the plan year). The final regulations retained the basic rule with two modifications to be consistent with the rule for QNECs. First, an employer may not take a QMAC into account under the ACP test to the extent it exceeds the greatest of 5% of compensation, the employee's elective deferrals for a year, and the product of two times the plan's representative matching rate and the employee's elective deferrals for a year. Second, in the case where the "matching rate" is not the same for all levels of elective contributions for an employee, the final regulations provide that the employee's matching rate is determined by assuming that he or she elects a 6% rate of elective deferrals. The final regulations generally define matching rate for an employee to mean matching contributions divided by the employee's elective deferrals for the year.

- Consistency in Testing. An employer may perform ADP and ACP nondiscrimination testing on a current-year or prior-year basis. The final regulations do not require that an employer use the same method for ADP and ACP testing (i.e., an employer can use prior-year testing for ADP purposes, and current-year testing for ACP purposes (or vice versa)). The final regulations also provide that if the methodologies are inconsistent, excess elective deferrals cannot be recharacterized as after-tax contributions or be taken into account under the ACP test, nor can QMACs be taken into account under the ADP test.
- Aggregation of ESOP and Non-ESOP Components of a Single Plan. Previously, an employer was required to disaggregate the ESOP and non-ESOP portions of its plan and apply two separate ADP and ACP tests: one for contributions to the ESOP portion and the other for contributions to the non-ESOP portion of the plan. The proposed and final regulations eliminate these disaggregation rules. Now an employer can aggregate the ESOP and non-ESOP portions of its plan for purposes of performing ADP and ACP testing and may aggregate all participant and matching contributions, not just those of the highly compensated employees. Employers may also aggregate a separate ESOP that provides for elective and matching contributions with a non-ESOP. Employers must still disaggregate an ESOP, however, for purposes of applying the coverage requirements of Section 410(b) of the Code and the general nondiscrimination requirements of Section 401(a)(4) of the Code to the ESOP.
- Distribution of Gap Period Earnings. The final regulations require that earnings during the gap period (i.e., the period between the end of the plan year and the date of distribution) be distributed if any gain or loss for the plan year is, or would be, credited to excess amounts during the gap period if the total account were to be distributed. The new rule will not apply to plans that are valued annually or, in certain cases, quarterly. The final regulations permit an employer to disregard income allocable to the excess contributions for a period that is no more than seven days before the distribution. As a result, so long as the distribution is made within seven days of the date the amount of the distribution is determined, any gain or loss that occurs prior to the distribution but after the determination will not need to be taken into account in the distribution. Interestingly, there is now an inconsistency between these final regulations and those under Section 402(g) of the Code (which limits the amount an employee can defer each year) as they relate to earnings in the gap period, because the 402(g) regulations are not so specific about the earnings calculation. For administrative convenience, however, we suggest that the rules set forth in the final regulations be used for any excess deferrals under Section 402(g), since we expect that the 402(g) regulations will eventually be modified to be consistent with the 401(k) regulations.

Safe Harbor Plan Rules

- Adoption of Safe Harbor 401(k) Plans. The final regulations exempt safe harbor 401(k) plans from ADP and ACP testing, provided certain requirements are met. Specifically, safe harbor provisions must (i) be adopted prior to the beginning of a plan year (with a limited exception for nonelective safe harbor contributions), (ii) specify whether the employer chooses to avoid nondiscrimination testing by making nonelective safe harbor contributions or matching safe harbor contributions, and (iii) remain in effect for a 12-month period. The final regulations also provide exceptions to the 12-month rule, which permit a short plan year under certain circumstances, including plan terminations for business hardship, mergers, or acquisitions.
- Catch-up Contributions. The proposed regulations did not provide for an exception to the requirement for safe harbor matching contributions with respect to catch-up contributions. After reviewing applicable statutory provisions, the IRS and Treasury determined that such an exception was not permitted. Accordingly, the final regulations also do not provide for such an exception. Because of the limits on compensation and elective deferrals, however, catch-up contributions generally will not be made from the first 5% of an eligible participant's compensation and, therefore, will not be eligible for safe harbor matching contributions.
- Notice Requirement. Each eligible employee must be provided with written notice of the employee's rights and obligations under a safe harbor plan. The final regulations provide that the notice may be in writing or in such other designated form as the Commissioner may prescribe, but do not provide any specific details about whether or how such communications may be distributed electronically. On July 14, 2005, proposed regulations (which will be the subject of a separate LawFlash) were issued on the use of electronic media to provide certain notices or to transmit employee elections or consents with respect to employee benefit arrangements. Until these regulations become final, an employer may continue to rely on existing guidance (i.e., Notice 2000-3, Q&A-7), which permits an employer to use electronic media to satisfy the notice requirement.

Distribution Rules

- Leased Employees. The preamble to the final regulations notes that a change of status from a common law employee to a leased employee will not be treated as a "severance from employment" that would permit a distribution to be made from the employee's 401(k) account.
- Hardship Distributions. The final regulations expand the list of safe harbor hardship events to include burial or funeral expenses for the employee's parent, spouse, child or dependent, as well as expenses for the repair of damage to the

employee's principal residence that would qualify as deductible casualty expenses. For hardships pertaining to medical expenses, the final regulations also expand the definition of dependent to include a non-custodial child.

- ESOP Dividends. Previously, resources available to meet an immediate and heavy financial need for hardship purposes did not include distributable ESOP dividends. Recent regulations under Section 404(k) of the Code, however, addressed this issue. Incorporating this guidance, the final regulations provide that a participant must obtain any dividends currently available from an ESOP before receiving a hardship distribution.

Miscellaneous Rules

- Partnerships and Sole Proprietors. The final regulations extend the partnership rules to sole proprietors whereby self-employed individuals (i.e., sole proprietors or partners) may fund elective deferrals during the plan year based on cash advances or draws.
- Nonforfeitability Requirement. The final regulations require that elective deferrals to a qualified CODA, which must be immediately nonforfeitable, be taken into account for purposes of determining whether a participant is nonvested under the break-in-service parity rule. As a practical matter, this means that prior service may virtually never be disregarded following a break in service under a 401(k) plan. This reverses the rule under the original regulations.
- Single Testing Method. Retaining the proposed regulations' requirement that all CODAs under a plan apply a single testing method, the final regulations restrict an employer's ability to aggregate plans that use different testing methods. For instance, an employer may not aggregate a plan that applies the ADP test with a plan that applies the ADP safe harbor. The final regulations also clarify that if a plan is disaggregated into separate plans under the rules of Section 410(b) of the Code, then each plan may apply a different testing method.

Open Items

Although the final regulations address an extensive number of issues, they do not address all of the potential issues under Sections 401(k) and (m). For instance, they do not address the timing of plan amendments if a plan is changing its ADP/ACP testing method. Likewise, they do not provide guidance on testing issues in the context of mergers and acquisitions.

Practice Points

Employers may not need to make any changes to their existing plan documents as a result of the final regulations since most of the rules incorporate requirements already covered in the Code and corresponding guidance. Employers may, however, need to make clarifying changes to their plans to comply with the final regulations, in addition to

changes that take into account certain rules that were not previously incorporated into the plan documents. For example, any plan provision that disregards prior service for vesting after a break in service may need to be modified or eliminated. In addition, employers may need to make a number of administrative changes to comply with the regulations. For instance, to reflect the new requirement to pay gap period income, an employer may need to revise its plan's ADP and ACP test corrective distribution procedures. Likewise, employers who wish to incorporate the new safe harbor hardship withdrawal rules will need to revise their hardship withdrawal documents and procedures to reflect the additional hardship events.

Effective Date

The “new” final regulations are effective for plan years beginning on or after January 1, 2006. An employer may apply these regulations to any plan year that ends after December 29, 2004, however, if the final regulations are applied in their entirety for that plan year and all subsequent plan years. In other words, an employer may not choose between the old and new regulations to obtain the most favorable results. In addition, any decision to apply these new regulations in the middle of the plan year requires that the plan be operated in accordance with these regulations for the entire plan year, not just the period after the decision to apply the regulations has been adopted. An employer that does not apply the new regulations for 2005 must continue to comply with the original regulations, the statutory provisions of Sections 401(k) and (m) of the Code, and applicable IRS guidance.

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If you have any questions or would like further information about the final 401(k) and (m) regulations, please contact any one of the following Morgan Lewis attorneys:

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