

ERISA

VIEWS

Issue No. 36

Winter 2004/2005

Published by TRI Pension Services, PMB 120, 9457 S. University Blvd., Highlands Ranch, CO 80126, www.cyberERISA.com
Publication date: January 26 2005

Topic: Significant Issues Addressed in Comprehensive 401(k) Regulations Issued on December 29, 2004

On December 29, 2004, the Treasury issued comprehensive final regulations on nondiscrimination testing rules applicable to 401(k) plans. In this issue of ERISA Views, we focus on the significant issues addressed in these regulations. Please note that this newsletter is not intended to be a thorough discussion of the nondiscrimination testing rules applicable to 401(k) plans. The discussion assumes that the reader has at least a basic understanding of these rules. Our intention, instead, is to help you focus on the way existing administrative practices or plan designs change under these regulations.

Effective date. The regulations are effective for plan years beginning on or after January 1, 2006. For a calendar year plan, this is the 2006 plan year. For a plan with a plan year ending June 30, this is the plan year beginning July 1, 2006, and ending June 30, 2007.

✪ Early implementation rule. Plans may elect to apply the final regulations for earlier plan years (but not earlier than the first plan year ending after December 29, 2004). For example, a calendar year plan could elect to comply with the regulations starting with the 2004 plan year or starting with the 2005 plan year, rather than waiting until the 2006 plan year. However, if the early implementation rule is elected, the regulations must be complied with in such earlier years in their entirety. In other words, electing into the final regulations early means the plan takes the good with the bad!

Correction to Issue #35 on Automatic Rollovers. In several places in Issue #35, we refer to the automatic rollover rule under IRC §401(a)(31)(B) as applying for involuntary distributions of "between \$1,000 and \$5,000" or "\$1,000 or more." Please note, the rule applies only if the amount is more than \$1,000. See IRS Notice 2005-5. Also, Notice 2005-5 makes clear that involuntary distributions to surviving spouses and to former spouses under QDROs are not subject to the automatic rollover rule. Issue #35 was published prior to the release of Notice 2005-5. Issue #9 of eRISA Update contains a complete summary of Notice 2005-5.

ERISA Views is designed to provide accurate information in regard to the complex subject matters covered, but TRI Pension Services disclaims any implied or actual warranties as to the accuracy of the written material and any liability with respect to such material. It is provided with the understanding that the preparer of this newsletter is not providing legal, accounting, or other professional advice.

Table of Contents for This Issue

<u>Review of existing law and guidance</u>	3
<u>How should plans be operated before the effective date of these regulations?</u>	5
<u>Issues addressed in this newsletter</u>	5
<u>Section ❶ - Basic ADP and ACP Testing Rules</u>	8
<u>A. Changing the testing method</u>	9
<u>B. Corrective distributions</u>	11
<u>Section ❷ - Special Rules for QNECs and Matching Contributions</u>	13
<u>A. “Targeted” QNECs</u>	13
<u>B. Limits on including NHC matching contributions in ACP test</u>	18
<u>C. Other issues relating to QNECs or contribution shifting</u>	22
<u>Section ❸ Aggregation and Disaggregation Rules</u>	24
<u>A. Otherwise excludable employees</u>	24
<u>B. ESOPs</u>	26
<u>C. Mandatory aggregation rule for HCEs</u>	27
<u>Section ❹ - Distribution Restrictions</u>	29
<u>Section ❺ - Safe Harbor 401(k) Plans</u>	32
<u>A. 12-month plan year rule</u>	32
<u>B. Allocation conditions on safe harbor matching contributions</u>	34
<u>C. Suspensions of employee contributions</u>	36
<u>D. Multiple plan participation by HCEs</u>	36
<u>Section ❻ - Miscellaneous Issues</u>	38
<u>A. Only HCEs were eligible in the prior plan year</u>	38
<u>B. Prefunding elective deferrals and matching contributions</u>	38
<u>C. Clarification of Vesting Rules</u>	41
<u>D. Plan document requirements</u>	41
<u>E. Definition of cash or deferred arrangement</u>	44
<u>F. Contingent benefit rule</u>	44

Review of existing law and guidance. These regulations provide a much-needed compilation of the statutory changes made since 1997 to the 401(k) testing rules and the piecemeal guidance that has been issued by the IRS in the form of Revenue Rulings, Notices and Revenue Procedures over the last six years. Here is a list of the existing rules and guidance that are consolidated by these regulations.

(1) Statutory changes made by the Small Business Job Protection Act of 1996 (SBJPA)

- Prior year testing method for ADP and ACP testing (effective in 1997)
- Modified method of making corrective distributions of excess contributions under the ADP test or excess aggregate contributions under the ACP test (i.e., distributing to the highly compensated employees (HCEs) with the highest amount of contributions) (effective in 1997)
- Two new plan design alternatives for demonstrating compliance with the nondiscrimination testing rules: SIMPLE 401(k) plans (effective in 1997) and safe harbor 401(k) plans (effective in 1999)
- Restoration of the 401(k) plan as an option for sponsorship by employers that are tax-exempt organizations or Indian tribal governments (effective in 1997)
- An alternative testing method that permits the plan to disregard from the ADP and ACP tests only the eligible nonhighly compensated employees (NHCs) who are “otherwise excludable” (i.e., eligible employees who would not be eligible if the plan required one year of service and attainment of age 21 for eligibility purposes) (effective in 1999)

(2) Statutory changes made by the Taxpayer Relief Act of 1997 (TRA '97)

- Exemption from ADP and ACP testing for plans maintained by State or local governments, regardless of whether the plans satisfy the safe harbor 401(k) plan rules (effective in 1997, but

these plans were deemed to comply with the ADP and ACP tests for earlier years)

- Elimination of the rule which treated matching contributions allocated to partners in a partnership as elective deferrals (effective in 1998)

(3) Statutory changes made by the Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA)

- Eligible employees who are at least 50 years old subject to higher elective deferral limits (“catch-up contributions”) (effective in 2002)***
- Repeal of the multiple use test (i.e., special test required when a plan was passing both the ADP test and the ACP test on the basis of the “2% spread test”) (effective in 2002)
- Safe harbor 401(k) plan is deemed to be a non-top-heavy plan if certain conditions are satisfied (effective in 2002) ***
- Matching contributions permitted to be used toward satisfying the employer’s liability to make top heavy minimum contributions to non-key employees (effective in 2002) ***
- Matching contributions required to vest under top heavy vesting schedules, even if the plan is not top heavy (effective 2002) ***
- The “separation from service” distribution event for elective deferrals replaced with “severance from employment” distribution event, thus eliminating the application of the “same desk rule” (effective in 2002)
- Post-hardship contribution suspension period reduced from 12 months to 6 months (effective in 2002)
- Elective deferrals may be designated as “Roth contributions” (i.e., contributed on an after-tax basis with attributable earnings distributed tax-free under rules similar to those which apply to Roth IRAs) (not effective until 2006) ***

*** These asterisked items are not addressed by the regulations. Catch-up contributions are addressed in final regulations issued on July 8, 2003. Subscribers to