PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the firm

April 2005

IRS Issues Final Regulations for 401(k) Plans and Proposes Rules on Designated Roth Contributions to 401(k) Plans

Introduction

The Internal Revenue Service (the "IRS") has issued final regulations governing 401(k) plans and proposed regulations regarding Roth contributions to 401(k) plans. Plan sponsors will need to make certain decisions regarding the design and administration of their plans to address these regulations.

The final regulations provide guidance for retirement plans containing cash or deferred arrangements under Section 401(k)[1] and matching contributions or employee contributions under Code Section 401(m). The final regulations generally restate the existing regulations under Sections 401(k) and 401(m), and incorporate changes in the law (*e.g.*, the Small Business Job Protection Act of 1996 and the Economic Growth and Tax Relief Reconciliation Act of 2001) and corresponding IRS guidance from 1994 to the present. 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 of the rules of the regulations, to the extent applicable, for that plan year and all subsequent plan years.

The proposed regulations, regarding Roth contributions, address a new type of contribution that may be made to 401(k) plans on an after-tax basis. When finalized, the regulations regarding Roth contributions will amend the final 401(k) plan regulations.

Contributions

The final regulations provide that a contribution is considered to be made pursuant to a cash or deferred arrangement only if the contribution is made after the relevant election. Thus, a contribution cannot be made in anticipation of an employee's election, nor can a contribution be made with respect to an employee's performance of services before the employee actually performs the services. Accordingly, employers may not pre-fund elective contributions in order to accelerate deductions or for testing under the actual deferral percentage ("ADP") test or the actual contribution percentage ("ACP") test. This is a reversal of the previous position taken by the IRS. The regulations do include, however, an exception to this rule for occasional early contributions made for bona fide administrative considerations. The regulations also clarify that the restriction on the timing of contributions is not intended to prevent a partner from deferring amounts that are paid to the partner throughout the year on account of services performed by the partner during the year.

The regulations also incorporate prior IRS guidance allowing for automatic enrollment in a cash or deferred arrangement ("CODA"). The regulations specify that a default enrollment may apply in the absence of an affirmative election; however, the regulations do not include a constraint on the percentage of compensation that may apply as the default. Accordingly, the regulations clarify that the percentage specified in prior IRS guidance was merely illustrative and need not be applied.

[1] All Section references are to the Internal Revenue Code of 1986, as amended.

Vesting

The regulations clarify the IRS' position with respect to vesting service following a break-in-service. 401(k) plans may not disregard the service of a participant with respect to unvested matching contributions until the participant has had a five-year break-in-service.

Distributions

The final regulations add funeral expenses (for a parent, spouse, child or dependent) and certain expenses relating to the repair of damage to an employee's principal residence to the list of events that are deemed to be immediate and heavy financial needs eligible for a hardship distribution. In addition, the final regulations provide that a hardship distribution is only permitted for medical expenses if they otherwise would be deductible by the participant. The regulations also permit a plan to disregard certain restrictions on the definition of dependent under the Working Families Tax Relief Act of 2004 in the case of hardship distributions for post-secondary education expenses and medical expenses for dependents.

While not included in the final regulations, the preamble to the regulation provides important information regarding the treatment of individuals who change in status from a common-law employee to a leased employee. The preamble states that the IRS' position is that such a change is not a severance from employment, and, therefore, not a distributable event. Plan sponsors who are considering outsourcing groups of employees should be aware of this clarification.

Testing

The final regulations address the mandatory disaggregation and permissive aggregation rules for purposes of ADP and ACP testing. The regulations eliminate the mandatory disaggregation requirement with respect to the employee stock ownership plan ("ESOP") and non-ESOP portions of a single plan for ADP and ACP testing. The regulations also state that all CODAs under a plan must use one testing method, but plans with inconsistent testing methods may not be aggregated.

Perhaps the most significant change under the regulations is a new restriction on the use of targeted qualified nonelective contributions ("QNECs") or "bottom-up QNECs" to satisfy either the ADP test or the ACP test. The IRS and Treasury Department have explained that they are concerned that employers, through the use of targeted QNECs, are able to make necessary corrections and pass the ADP or ACP test by contributing QNECs to only certain non-highly compensated employees ("NHCEs") in an effort to minimize the total contributions made to NHCEs. To address this concern, the final regulations prohibit a plan from counting QNECs for ADP or ACP testing purposes if the QNECs are disproportionately contributed to certain NHCEs. This restriction is implemented by providing that a QNEC for a NHCE that exceeds 5% of compensation may only be taken into account for testing to the extent the contribution, when expressed as a percentage of compensation, does not exceed two times the plan's representative contribution rate (which is defined as the lowest contribution rate among a group of NHCEs that is half of all the eligible NHCEs under the arrangement). A 10% threshold, instead of a 5% threshold, must be used in connection with a prevailing wage obligation under the Davis-Bacon Act or similar legislation.

The final regulations clarify that for plans which use prior-year testing, QNECs for NHCEs must be contributed no later than the last day of the plan year being tested. Also, income earned on excess contributions during the "gap period" (the period following a given plan year) must be distributed along with the excess contributions, subject to special timing rules for these calculations.

The final regulations also include an anti-abuse rule which generally restricts a plan's ability to make repeated changes in testing procedures or plan provisions which have the effect of distorting ADP or other nondiscrimination testing.

Roth Contributions

Beginning in 2006, Section 401(k) plans will be permitted to allow employees to designate all or a portion of their elective contributions as "Roth contributions." Unlike typical elective contributions that are made on a pre-tax basis, Roth contributions will be included in a participant's income and subject to tax—similar to after-tax participant contributions that many plans allow. However, unlike current after-tax contributions, earnings on Roth contributions will generally be subject to taxation under the rules applicable to Roth IRAs (*i.e.*, not be taxable when distributed from a plan).

Under the proposed regulations, designated Roth contributions are defined as elective contributions under a qualified CODA that are: (1) designated irrevocably by the employee at the time of the cash or deferred election as designated Roth contributions; (2) treated by the employer as includible in the employee's income at the time the employee would have received the contribution amounts in cash if the employee had not made the cash or deferred election (by treating the contributions as wages subject to applicable withholding requirements); and (3) maintained by the plan in a separate account.

Contributions may only be treated as designated Roth contributions to the extent permitted under the plan. In addition, the availability of each level of elective contribution is a right or feature subject to nondiscrimination testing and the right to make a

designated Roth contribution is a right or feature that will be subject to nondiscrimination testing. However, for purposes of ADP testing, Roth contributions will be treated like a pre-tax elective contribution made by a participant, and therefore, will be counted in determining relevant deferral percentages.

Contributions and withdrawals of designated Roth contributions must be separately credited and debited to a designated Roth contribution account maintained for the employee and the plan must maintain a record of designated Roth contributions that have not been distributed. In addition, gains, losses, and other credits or charges must be separately allocated on a reasonable and consistent basis to the designated Roth contribution account and other accounts under the plan. However, forfeitures may not be allocated to the designated Roth contribution account. Designated Roth contributions are subject to the same nonforfeitability and distribution rules as elective contributions and will also be subject to ADP testing and the required minimum distribution rules.

Other Provisions

The regulations also reflect prior guidance and clarifications including provisions regarding safe harbor plans, the same-desk rule, treatment of self-employed individuals, and refinements in ACP testing.

Implications for Plan Sponsors

Plan sponsors should consult with their Proskauer employee benefits attorneys to determine how the final regulations affect the design and administration of their plans. While all 401(k) plans must be in operational compliance with the final regulations no later than the first day of the plan year beginning on or after January 1, 2006, the IRS has not yet issued guidance on when 401(k) plans are to be amended to reflect the final regulations. We will keep you apprised of the timing for required amendments once guidance is issued. Final regulations for Roth contributions are expected this year; until final regulations are issued, plan sponsors need only contemplate, with the consultation of their recordkeepers, whether they will add this new feature to their plans.

Client Alert

The Employee Benefits and Executive Compensation Law Practice Group at Proskauer Rose LLP counsels clients on the full spectrum of benefit and compensation issues, communicating technical and complex legal concepts in an intelligible, pragmatic manner.

The following individuals serve as contact persons with respect to this Client Alert and would welcome any questions you may have:

Jacob I. Friedman
212.969.3805 – jfriedman@proskauer.com

Ian L. Levin
212.969.3237 – ilevin@proskauer.com

Lisa A. Herrnson
561.995.6111 – lherrnson@proskauer.com