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Re: IRS Publishes Final 401(k) and 401(m) Regulations

Dear Clients and Other Friends:

Last month, the IRS finalized its comprehensive revision of the regulations affecting pre-tax, after-tax and matching contributions. The new regulations were needed to bring the regulations under Code §401(k) and Code §401(m) into conformity with the numerous statutory changes that have occurred since 1994 when the §401(k) and §401(m) regulations were last amended.

The 2004 final regulations largely adopt the positions taken by IRS in interim guidance and are substantially similar to the proposed comprehensive regulations that were issued in July, 2003, but they also include some significant clarifications and a few new provisions that plan sponsors and administrators will need to note and incorporate into their plans and practices.

The new regulations apply no later than the first plan year beginning in 2006. Plans may begin to apply the new rules earlier, i.e., to any plan year ending after December 29, 2004, but only if the rules – in their entirety – are applied to that full plan year and to all subsequent years. This all-or-nothing approach will, unfortunately, force some plans to delay using helpful portions of the new rules, like the change in testing ESOP contributions, until other plan practices can be brought into compliance.

The following highlights some of the most significant aspects of the new regulations.

I. Discrimination Testing

- ***Mandatory disaggregation of ESOPs eliminated.*** When average deferral percentage (ADP) and average contribution percentage (ACP) testing is done, the boundaries of the plan being tested are generally determined using the same aggregation and disaggregation rules that are used to define a plan for coverage testing purposes (Code section 410(b)). Those rules mandate the separate testing of ESOPs and non-ESOPs, which has complicated ADP and ACP testing and led some sponsors to make design changes to avoid testing failures. The final regulations eliminate the need for design work-arounds and dual testing by waiving ESOP mandatory disaggregation for purposes of the §401(k) and §401(m) regulations, including both the ADP and ACP tests.

- ***Testing changes subject to new anti-abuse provision.*** In response to concern that plan sponsors were abusing the bright-line nondiscrimination tests by making repeated changes between otherwise acceptable testing techniques, the final regulations add a prohibition on repeated changes to testing procedures and/or plan provisions if a principal purpose of those changes is to benefit highly compensated employees. The current clear numerical tests have thus been muddled by the introduction of what amounts to a facts and circumstances determination for testing changes. While the preamble to the final regulations seeks to assure sponsors that the rule is only aimed at abusive actions, and the rule itself is laced with language that should restrict application of the rule, the rule could nevertheless be a source of ongoing uncertainty both because of its vague subjective standard and because maximizing the ability of highly compensated employees to contribute strikes most plan sponsors as a perfectly legitimate design goal. Until it becomes clear that enforcement will be limited to the most egregious cases, the difficulty in distinguishing between mere use and manipulative abuse may, unfortunately, lead some sponsors to avoid permissible changes and give others one more thing to worry about.
- ***Aggregation of plans that use inconsistent testing methods prohibited.*** While the final regulations explicitly authorize the use of different testing methods for the ADP and ACP tests, they also indicate that plans (determined after application of the disaggregation rules) cannot be aggregated for testing purposes if they use different testing methods. For example, a plan using the current-year testing method may not be aggregated with a plan that uses the prior-year method, and a plan that uses the ADP safe harbor cannot be aggregated with a plan that uses numerical ADP testing.

II. Safe Harbors

- ***Catch-up contributions must be matched.*** After soliciting comment on possible exceptions to the matching obligation, IRS has concluded, and the final regulations reflect, that there is no exception to the safe harbor matching obligation for catch-up contributions. As a result, if a participant hasn't satisfied the safe harbor match requirement before catch-up contributions begin, some of those catch-up contributions may need to be matched.
- ***Twelve-month requirement.*** The final regulations generally require that a safe harbor be maintained for a full 12-month plan year in order to ensure that the benefits to non-HCEs are sufficient to support what could be a full year's contributions by HCEs. The regulations adopt several exceptions to the 12-month rule, however, including exceptions for plan termination, plan termination in connection with an event like a

merger or acquisition, and short plan years that are both preceded and followed by full years in which the plan uses the safe harbor.

III. Correction Methods

- ***Limits on use of disproportionate QNECs.*** One technique for the correction of ADP and ACP testing failures that the IRS has found particularly troubling is the practice of granting disproportionate qualified nonelective contributions (QNECs) to an employer's lowest paid employees, in order to inexpensively raise the contribution average. In its extreme form, QNECs would be made first to the lowest paid employee until either the testing failure was corrected or the limit on annual additions under Code section 415 was reached for that employee. If the test was not passed by contributions to that employee, contributions would then be made to the next lowest paid employee until either the test was passed or the 415 limit was reached. This "bottom-up leveling technique" is prohibited by the final regulations, which impose a cap on the amount of QNECs made to any employee. The cap is generally equal to the greater of 5% of compensation or two times the plan's "representative contribution rate", which the regulations define by reference to the lowest applicable contribution rate of any non-HCE in a group consisting of at least half of all of the eligible non-HCEs during the applicable year (or if higher, the lowest such rate among the eligible non-HCEs who are still employed at the end of the year). The "applicable contribution rate" takes into account both qualified matching contributions (QMACs) used to pass ADP testing and QNECs. The final regulations add a special higher 10% limit for QNECs made in connection with an employer's obligation under the prevailing wage rules of the Davis-Bacon Act. Parallel restrictions apply to QNECs taken into account for ACP testing, and the regulations prohibit the same QNECs from being used to pass both tests.
- ***Limits on targeted QMACs.*** To prevent a similar targeted correction method using matching contributions, the final regulations also prohibit taking into account QMACs that exceed the greatest of: (i) 5% of the employee's compensation, (ii) the employee's elective deferrals for the year, and (iii) the product of two times the plan's representative matching rate and the employee's elective deferrals for the year. The "representative matching rate", similar to the "representative contribution rate" for QNECs, is defined by reference to the lowest matching rate of any eligible non-HCE in a group consisting of at least half of all of the non-HCEs who make matched deferrals/contributions during the applicable year (or if higher, the lowest matching rate among the eligible non-HCEs who are still employed at the end of the year).
- ***Distribution of gap period income required.*** Currently, plans have the option whether to distribute income attributable to the period between the end of the tested year and the date of distribution. Under the final regulations, such "gap period"

income will have to be distributed, but only to the extent the income would have been paid if the total account were distributed. The final regulations also provide that the method of determining gap period income will not be considered unreasonable if it is calculated as of a date that is no more than 7 days before the date of the corrective distribution.

- ***Excess contribution timing rules.*** Under the final regulations, distributed excess contributions will be includible in income on the dates the income would have been received absent the deferral, assuming that the excess contributions were the first contributions made by the employee during the year.

IV. Hardship Distributions

- ***New deemed hardship distributions.*** Although many plans have treated funeral expenses as hardships, the final regulations for the first time make funeral expenses for a parent, spouse, child or dependents (determined without regard to the income test in Code section 152(d)(1)(B)) one of the categories of expenses that are automatically deemed to be a hardship. Also added is a deemed hardship for repair of damage to a principal residence that would qualify for the casualty deduction under Code section 165 (determined without regard to the 10% of adjusted gross income test).
- ***Disregard certain recent changes in the definition of dependent.*** The final regulations modify the medical expense and post-secondary education hardship rules to disregard certain recent changes in the definition of dependent. Moreover, the preamble to the regulations indicates that plans can continue to interpret their plan provisions without regard to the statutory change in the definition of dependent made by the Working Families Tax Relief Act of 2004, even before the final regulations apply.
- ***Medical expense definition modified.*** The final regulations make deductibility under Code section 213(d)(determined without regard to whether the expenses exceed 7.5% of adjusted gross income) the standard for identifying qualifying medical expenses. As a result, non-prescription drugs or medicine (other than insulin) will not qualify.

V. Other Changes Affecting Current Practices

- ***Most prefunding of elective and matching contributions prohibited.*** With a few exceptions – including exemptions for certain ESOP suspense account allocations used as match, forfeitures used as match, and occasional prefunding due to bona fide administrative considerations – elective contributions generally cannot be made before the services are performed that earn the deferred income. Amounts that are

contributed prematurely generally will not be treated as elective contributions under §401(k), and match contributed prematurely will be unavailable for ADP and ACP testing purposes.

- ***Documents must incorporate testing options.*** The 2004 final regulations require that plan documents identify the nondiscrimination testing alternative that will be used by the plan. If a plan identifies itself as a safe harbor plan, it cannot provide for a default to ADP testing if safe harbor requirements are not met. In addition to identifying the testing alternative, the plan document must also choose from among any options that are available under the testing alternative chosen. Thus, if a plan chooses to use ADP or ACP testing, any optional choices available under those tests – such as the choice between current-year versus prior-year testing, and, if prior-year testing is used in a new plan, how the average for the non-HCEs will be determined in the first year – must be identified in the plan document. Similarly, if a plan decides to use the safe harbor approach, it must indicate whether non-elective contributions or matching contributions will be used to satisfy the safe harbor.

VI. Guidance That Confirms Existing Understandings

- ***Negative elections explicitly sanctioned.*** The final regulations confirm that it does not matter whether a plan makes contributing or not contributing the default for a 401(k) plan. The preamble to the regulations also confirms that the default percentage used in previous guidance on automatic enrollment was merely illustrative and that the final regulations do not impose any restrictions on the default provisions.
- ***Catch-up and USERRA make-ups ignored for testing.*** The final regulations confirm that neither catch-up contributions nor contributions made on account of qualified military service are counted in discrimination testing.

VII. Other Noteworthy Details

The final regulations also include:

- Special rules for designated Roth-IRA contributions;
- Rules for changing from current-year to prior-year testing;
- ADR calculation details for HCEs who participate in more than one cash-or-deferred arrangement; and
- Changes to the definition of a one-time irrevocable election to receive contributions that are not treated as elective contributions.

As noted above, the new regulations assemble and organize a significant body of existing guidance. Most plans will have already incorporated and be operating in compliance with most of the new regulations. The new regulations do include a few major changes and a lot of minor

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ones, however, so the compliance challenge for most plans will be to identify which of the truly new rules are relevant and to make timely operational and documentary changes as needed. As usual, the devil is in the details, and there will be no substitute for a careful comparison of plan operations to the new rules.

Plans that discover they are compliant already are free to consider applying the new regulations early to their 2005 plan year in order to take advantage of some of the new rules. This possibility may be most appealing to ESOPs, whose testing will be greatly simplified by the elimination of mandatory disaggregation for the ADP and ACP tests.

As always, if we can be of assistance in assessing how the new regulations will affect your plans, please let us know.

Sincerely,

John W. Haine

JWH/hgn