

TRISTAR PENSION CONSULTING

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IRS Issues Final 401(k) Regulations

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The Internal Revenue Service has at long last issued final regulations under sections 401(k) and 401(m) of the Internal Revenue Code. The regulations, issued on December 29, 2004, make some significant changes to the proposed regulations issued in 2003, and update the final regulations issued back in 1994. Since that time, numerous statutory changes have taken place, as well as revenue rulings and procedures which are all reflected in the new regulations.

The final regulations are quite extensive. This article will review some of the most significant provisions and their impact on the administration of 401(k) plans.

NONDISCRIMINATION TESTING

Most 401(k) plans must pass annual nondiscrimination tests regarding employee deferrals and employer matching contributions. The tests compare contributions made on behalf of "highly compensated employees" (HCEs) with contributions made on behalf of "non-highly compensated employees" (NHCEs). HCEs are defined as more than 5% owners of the employer in the current or the previous plan year and those who received compensation in the previous plan year in excess of a specified level (\$90,000 for 2004 and \$95,000 for 2005).

The nondiscrimination tests require average contributions for the HCE group to be within a certain range of the average contributions for the NHCE group. The maximum average HCE contribution, as a percentage of compensation, is based on the average NHCE percentage as follows:

| NHCE Percentage | Maximum HCE Percentage |
|--------------------|---------------------------|
| 2% or less | NHCE % x 2 |
| 2% - 8% | NHCE % + 2 |
| 8% or more | NHCE % x 1.25 |

Plans that do not pass the test must take some action, such as making corrective distributions or additional employer contributions.

TESTING METHOD

Plans may choose current year testing, where current year contributions are used to compare the percentages of both HCEs and NHCEs, or prior year testing, where the contributions for NHCEs in the prior year are compared with HCE contributions in the current year. The prior year testing method gives employers the average contribution limitations for the HCEs in advance and reduces the chances of a failed test.

Another option exists for the first year of a plan utilizing the prior year method. It can choose to use 3% for the average contributions for NHCEs, or it can use actual NHCE contributions in the first year.

The regulations provide that a plan does not have to use the same testing method for deferrals (the ADP test) as it does for matching and voluntary after-tax contributions (the ACP test). This may be relevant where a plan allows for discretionary matching contributions but chooses not to make any in certain years. Such a plan would have to use current year testing for the ACP test but might prefer prior year testing for deferrals.



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Whatever testing methods are chosen, the regulations require them to be specified in the plan document. The testing methods may only be changed by amendment, subject to certain restrictions on changing from current year to prior year testing. The regulations also provide that changes in testing methods or procedures cannot be done in such a manner as to be abusive in benefiting HCEs.

QNECS AND QMACS

One method of correcting a failed nondiscrimination test is having the employer make a "qualified nonelective contribution" (QNEC) or "qualified matching contribution" (QMAC). QNECs and QMACs are required to be immediately 100% vested and subject to withdrawal restrictions. These contributions must be deposited by the last day of the following plan year. For that reason, these contributions are not very practical with the prior year testing method, because the deposit would have to be made by the last day of the testing year, which is usually before the tests can even be performed.

There are a number of ways that QNECs and QMACs can be allocated to participants. One of the more controversial ways is referred to as a "bottom-up" or "targeted" QNEC. Additional contributions are made to one or more of the NHCEs with the lowest compensation. The contribution can be a very large percentage of the compensation for these individuals and still not cost the employer a lot of money. These large percentages can have a big impact in helping the plan pass the nondiscrimination tests.

However, the final regulations have added restrictions which severely limit the impact of these types of allocations. Under the new rules, QNECs in excess of 5% of compensation for any individual may only be used for testing purposes if additional requirements are met. Here is a comparison of the old and new rules:

The ADP for Hobbit Company is 3% for its 50 NHCEs and 6% for its 5 HCEs. The test is failed since the maximum ADP permitted for HCEs is 5% (3% NHCE + 2). Under the prior rules, Hobbit Company could make a QNEC of 25% of compensation for 2 employees earning \$1,000 which would increase the NHCE ADP to 4% and only cost the employer \$500 to pass the test.

However, the final regulations will limit the QNEC in the above example to 5% of compensation. Therefore, 10 NHCEs will need to receive 5% of compensation to pass the test which may considerably increase the cost of passing the test compared to the prior rules.

An exception was made for prevailing wage plans (under the Davis-Bacon Act) that allows QNECs of up to 10% to be used for testing purposes.

The new provisions could also impact QNECs and QMACs allocated on a flat dollar basis since a specific dollar amount will represent a higher percentage of a lower-paid employee's compensation than a higher-paid employee's compensation.

Similar rules apply for QMACs with some variations concerning the matching contribution.

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GAP PERIOD EARNINGS

The most common method used to correct a failed nondiscrimination test is to make corrective distributions of excess contributions to HCEs. The excess contributions are required to be adjusted for related investment earnings or losses. These contributions are presumed to be the first deposits made during the plan year, and under prior rules, did not have to be adjusted for earnings from the end of the plan year until the distribution date (referred to as the "gap period").

Under the final regulations, earnings during the gap period can no longer be ignored for certain plans. Earnings for the gap period must be included if there was a valuation date during the period, e.g., daily valued plans. If there is no valuation date within the gap period, no gap period earnings are required. For example, a calendar year plan that has quarterly valuation dates will not need to include gap period earnings for a distribution made in February since there was no valuation since the end of the plan year.

Plans with daily valuations must calculate income within seven days of the distribution date. But since it is extremely difficult to estimate exactly when the distribution will actually be processed, some plans may want to use the safe harbor calculation provided in the regulations. Under this method, 10% of the income for the preceding plan year is multiplied by the number of months in the gap period, including the month of payment if the corrective distribution is made after the 15th of the month. For example, corrective distributions made on March 15th would have a gap period adjustment of 20% of the preceding plan year earnings.

SAFE HARBOR 401(K) PLANS

Safe harbor 401(k) plans are exempt from nondiscrimination testing if they satisfy certain contribution and notice requirements. These plans must provide either a 3% nonelective contribution to eligible employees or a minimum matching contribution of 100% of the first 3% of compensation deferred and 50% of the next 2% of compensation deferred.

The final regulations provide that the plan document must contain the relevant provisions if a plan chooses to avoid nondiscrimination testing by making safe harbor contributions. The plan cannot state that it will revert to testing if the contribution or notice requirements are not met.

The regulations also allow safe harbor plans to have short plan years under certain circumstances involving plan terminations for business hardship, mergers or acquisitions. In addition, the rules regarding safe harbor matching contributions apply to catch-up contributions as well as other elective deferrals.

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; and
- Repair of damage to the employee's principal residence that would qualify as deductible casualty expenses.

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For hardships pertaining to medical expenses, the definition of dependent has been expanded to include a non-custodial child.

OTHER PROVISIONS

Guidance was also provided for the following issues:

AUTOMATIC ENROLLMENTS

Plans may provide for a default deferral election if no affirmative election is made by a participant (e.g., an election form is not returned). There is no limit on the amount of the default election.

ONE-TIME IRREVOCABLE ELECTION

Under the final regulations, an employee can make a one-time irrevocable election not to participate in a retirement plan up until the date of participation. The election applies for the duration of employment with the employer.

TIMING OF DEFERRAL CONTRIBUTIONS

In general, elective deferral and matching contributions cannot be funded prior to the performance of services for which compensation is being deferred or matched. However, an exception was established for occasional administrative necessities, such as when a bookkeeper will be out of the office when the contributions must be deposited.

EFFECTIVE DATE

The final regulations are effective for plan years beginning on or after January 1, 2006. However, plan sponsors can apply the new rules for any plan year ending after December 29, 2004, provided the plan applies all of the rules of the final regulations, to the extent applicable, for that plan year and all subsequent plan years.

CONCLUSION

The final 401(k) and 401(m) regulations address an extensive number of issues involving plan administration. For the 2005 plan year, plan sponsors may continue to operate their plans under the prior regulatory guidance. However, plan sponsors should consult with their advisors to determine how the final regulations will affect their plans beginning in 2006.

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