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Employee Benefits Briefing

A bulletin designed to keep clients and other friends informed on employee benefits law matters

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UPDATED 401(k) PLAN REGULATIONS FINALIZED

Updated final regulations were recently issued covering 401(k) plans. Pre-tax contributions made by 401(k) plan participants are tested for discrimination each year under the actual deferral percentage (ADP) test under Section 401(k) of the Internal Revenue Code of 1986, as amended (the "Code"). The combined amount of employer matching and employee after-tax contributions are tested under the actual contribution percentage (ACP) test under Section 401(m) of the Code.

These regulations update and revise regulations that were issued in 1994 following the comprehensive changes made to 401(k) plans by the Tax Reform Act of 1986. Since 1994, Congress has enacted many other changes impacting 401(k) plans, such as: (a) revising the refund method for highly compensated employees when the ADP or ACP test is not met; (b) revising the highly compensated employee definition; (c) permitting plans to use the prior year ADP/ACP testing method; (d) permitting plans to use fully vested safe harbor contributions instead of testing (although the ACP test must always be performed for after-tax contributions); (e) permitting participants who are at least age 50 to make catch-up contributions that are not subject to testing or contribution limits; (f) permitting plans to exclude from ADP/ACP testing nonhighly compensated employees who are under age 21 or have not completed one year of service; (g) eliminating the multiple-use test that often applied when there was both ADP and ACP testing; (h) reducing the contribution suspension period following a hardship withdrawal from one year to six months; and (i) requiring faster vesting for matching contributions. The final regulations are updated to reflect all these changes.

The following is a summary of key provisions of the new regulations:

1. *Effective Date*. Generally, the new regulations are not effective until the plan year beginning in 2006. However, for plan years ending after December 29, 2004, an employer can elect to apply the new regulations. In this case, the employer must use all of the new regulations for the entire plan year and for all subsequent years. Thus, an employer may not elect to use only part of the new regulations before 2006. When conforming amendments are made to an employer's 401(k) plan, they should reflect when the employer started using the new regulations.

2. *Election Not to Participate in a Plan*. The regulations reiterate that a 401(k) plan is the exclusive method by which an employee may elect to reduce his or her compensation on a pre-tax basis in exchange for a contribution or benefit under a qualified retirement plan. However, the regulations continue to allow an employee to make a one-time *irrevocable* election not to participate in all of an employer's tax-favored retirement plans or arrangements (broadly defined) in exchange for higher compensation payments. Such an election must be made before the time that an employee is first eligible to participate in any such plan or arrangement.

3. *Automatic Enrollments*. The regulations incorporate prior IRS guidance allowing an employee to be automatically enrolled in a 401(k) plan, unless he or she affirmatively elects not to participate and has an effective opportunity to make the election. Employers

have flexibility in establishing the pre-tax contribution level under the terms of the plan document for automatic enrollments. The regulations reiterate the Department of Labor's position that, unless a participant makes an affirmative investment election, plan fiduciaries will continue to be responsible for these investments, even if a default investment is specified in the plan.

4. *Testing Methods Must be Stated in Plan Document*. The regulations require that the ADP/ACP testing method used—prior year or current year testing—be stated in the plan document. Prior year testing compares the contributions made on behalf of nonhighly compensated employees in the prior year against those on behalf of highly compensated employees in the current year (often referred to as the *testing year*). A new plan using prior year testing may state that an assumed 3% average contribution rate for nonhighly compensated employees for its first testing year will be used. Plans may be aggregated for testing only if they use the same testing method. A plan using one of the safe harbor contribution methods must specifically state which method is being used and satisfy participant notification rules. Although a safe harbor plan is generally not permitted to fall back on ADP/ACP testing for a year, a plan may be amended prospectively out of safe harbor status *during* a plan year if participants are provided with 30 days prior notice. In this case, the plan would have to meet the ADP/ACP tests for the entire year by using current year testing.

5. *Gap Period Income*. Refunds required under a 401(k) plan generally must reflect investments for the contribution year and, in a change from the prior regulations, for a portion of the next plan year until the refund is made (for the refund year, this is known as the "gap period"). However, gap period income has to be refunded only if the gap period encompasses a plan valuation date (for example, the gap period includes a daily, monthly or other plan valuation date) Also, gap period income for a period of up to seven days before a refund is made does not have to be included.

6. *Hardship Withdrawals*. The new regulations reflect the statutory change reducing an employee's contribution suspension period after a hardship withdrawal to six months from twelve months. This suspension encompasses all employee pre-tax and after-tax contributions under qualified and nonqualified plans and stock option, stock purchase or similar plans, but not mandatory contributions under a defined benefit pension plan. The requirement that a participant receive all available plan loans and distributions before obtaining a hardship withdrawal was modified to include ESOP dividends that a participant may elect to receive under the plan. Funeral expenses and certain expenses for the repair of a participant's principal residence were added to the list of events that can be deemed to be hardships for a participant, spouse or dependent without requiring actual verification by the plan administrator. Also, the new, more restrictive definition of dependent under the Section 152 of the Internal Revenue Code does not apply here.

7. *Elimination of ESOP Disaggregation Testing Rule*. When a 401(k) plan has an ESOP component, the current regulations require that the ESOP component be treated as a separate plan for ADP/ACP testing purposes. This may require two ADP and two ACP tests for each year. The new regulations eliminate this rule once they are effective.

8. *Contributions Excluded From Testing*. The regulations were revised to reflect the rule excluding catch-up contributions from the ADP test. Make-up contributions when an eligible employee returns to active employment after qualified military service are also excluded from ADP/ACP testing.

9. *Participants Excluded From Testing*. The new regulations still allow employers to treat highly and nonhighly compensated employees who are under age 21 or have not completed one year of service as a separate group for ADP/ACP testing. Alternatively, an employer can elect to exclude from testing altogether those nonhighly compensated employees who have not met those requirements.

10. *Special Employer Testing Contributions*. An employer can make additional qualified nonelective contributions, or *QNECs*, to satisfy the ADP or ACP tests. Also, matching contributions that are not needed for the ACP test can be recharacterized as qualified matching contributions, or *QMACs*, and used for the ADP test.

These contributions must be fully vested, only be counted for one of the tests, not be distributed in-service (including a hardship withdrawal) before age 59½ and (as a practical matter) only made for nonhighly compensated employees. The new regulations significantly limit the "bottom-up leveling method" where QNECs are made only for the lowest paid nonhighly compensated employees until the ADP or ACP test is met. Generally, QNECs may not be included in ADP or ACP testing to the extent they exceed, as a percentage of compensation, the greater of: (a) 5% or (b) two times the lowest amount of QNECs and QMACs of any nonhighly compensated employee that is either in a group comprising 50% of the eligible nonhighly compensated employees or (if greater) employed on the last day of the plan year.

11. ***Timing of QNECs***. When a plan uses the current year testing method, QNECs can be made up to 12 months after the end of the testing year. However, when a plan uses prior year testing, QNECs must be made *before* the last day of the testing year. For purposes of the annual additions test under Section 415(c) of the Code, QNECs are generally taken into account for the testing year. However, QNECs made more than 30 days after the employer's income tax filing due date (including extensions) are included under Section 415 for the actual year made.

AUTOMATIC ROLLOVER OF MANDATORY DISTRIBUTIONS

On March 28, 2005, eligible rollover distributions in excess of $1,000 but not more than $5,000 are subject to the automatic rollover requirements.

Background

Section 401(a)(31) of the Internal Revenue Code of 1986, as amended (Code), provides that an eligible rollover distribution whose current value is $5,000 or less may be cashed out as a mandatory distribution without the participant's consent. These rules apply to all qualified plans including defined benefit pension plans, as well as 403(b) plans.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended Code Section 401(a)(31) by requiring mandatory distributions in excess of $1,000 to be rolled over to an IRA established by the plan administrator unless the participant has affirmatively elected a direct distribution or other rollover. Plan administrators must notify participants that, absent an election, eligible rollover distributions between $1,000 and $5,000 will automatically be rolled over to an IRA. An explanation of the automatic rollover procedures may appear in the summary plan description or in a summary of material modifications.

DOL Safe Harbor Regulation

On September 28, 2004, the DOL issued final regulations establishing safe harbors for plan fiduciaries making such rollovers, as described in our October 2004 *Employee Benefits Briefing*. Plans must have procedures in place to adequately process automatic rollovers made on and after such date. The safe harbors established under the regulations provide the conditions under which plan administrators are deemed to satisfy their fiduciary responsibilities when (i) designating an institution to receive the automatic rollover and (ii) selecting the initial investment fund.

IRS Guidance

IRS Notice 2005-5 provides further guidance for implementing automatic rollover procedures. Plan administrators may execute, on behalf of the participant, documents necessary to establish an IRA with a financial institution without violating the customer identification program under the USA Patriot Act. A grace period exists until December 31, 2005 for plans which are unable to process a mandatory distribution beginning March 28, 2005 due to a lack of administrative procedures. Plans cannot make involuntary cashouts over $1,000 after March 28, but do have until December 31 to implement the automatic rollovers.

In order to comply with the notice requirement, either the standard notice of special tax rules must be revised or a separate notice provided to the participant. The IRS has not yet updated the standard notice.

If a distribution is subject to mandatory distribution even though it is greater than $5,000 due to a rollover contribution, the entire amount is also subject to the automatic rollover rules if the participant does not provide other distribution instructions.

Notice 2005-5 also contains a "good faith" amendment which must be adopted by the end of the first plan year ending on or after March 28, 2005. Alternatively, plans may be amended to avoid the automatic rollover procedures without violating the anti-cutback rules under Section 411(d)(6) by reducing the mandatory cash out amount to $1,000 or less. However, this would require the plan to retain the small accounts or benefits within the plan.

NEW HIPAA HEALTH CARE PORTABILITY REGULATIONS

On December 30, 2004, the Departments of Treasury, Labor and Health and Human Services jointly issued final and proposed regulations regarding the portability requirements under the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"). These regulations make certain changes and clarifications to the interim regulations issued in 1997 and are effective for plan years beginning on or after July 1, 2005. Health administrators will need to review their forms and procedures to ensure compliance with the final regulations. The following is a brief summary of the highlights.

Pre-Existing Condition Exclusions

The final regulations provide that any provision excluding benefits based on the existence of a condition before the effective date of coverage will be subject to the limitations on pre-existing condition exclusions even if it is not designated as such. For example, a plan provision that excludes certain illnesses or injuries incurred before becoming covered by the plan would be subject to HIPAA's limits.

The regulations also set forth certain requirements for the notice of a plan's pre-existing condition exclusion that must be provided with the enrollment material. Sample language that will satisfy this requirement is included in the final regulations.

The regulations also clarify that a plan cannot limit the time in which a participant may present a certificate of creditable coverage to limit or reduce the pre-existing condition exclusion time period.

Certificates of Creditable Coverage

Under the final regulations, the certificates must include an educational statement explaining certain aspects of HIPAA, including pre-existing exclusion limitations, special enrollment rights and health status nondiscrimination restrictions. A "model" certificate is included in the regulations.

The final regulations also require plans to have written procedures for requesting certificates of creditable coverage.

Special Enrollment

The final regulations appear to expand prior understanding regarding special enrollment rights, primarily through examples clarifying that certain events give rise to such rights, including: a dependent reaching the age at which he/she is no longer covered, losing region-specific HMO coverage due to a relocation, and reaching the lifetime maximum benefit amount.

In addition, the regulations provide that whenever a participant adds a dependent or a dependent obtains special enrollment rights, the participant and all dependents have the right to enroll in any plan of the employer, not just the plan covering the participant at the time. Special enrollees must be offered all options, subject to the same conditions and costs, as all other participants.

PROPOSED REGULATIONS

The proposed regulations clarify how HIPAA coordinates with the Family and Medical Leave Act ("FMLA"). The period of time a person is on FMLA leave, but does not continue health coverage, is not taken into account in determining whether a significant (63-day or more) break in coverage has occurred that would cause a loss of prior creditable coverage.

In addition, the model certificate would be further revised to include information on the interaction of HIPAA with the FMLA. The 63-day break-in-coverage would not start for any covered individual until a certificate of creditable coverage is issued, but this tolling period is limited to a maximum of 44 days.

The proposed regulations also clarify special enrollment rights procedures. A request for special enrollment may be made orally or in writing, and the deadline for completing enrollment material must be extended for individuals making reasonable efforts to obtain needed information (such as a newborn's social security number).

PHASED RETIREMENT REGULATIONS PROPOSED

The IRS recently released proposed regulations that will permit phased retirement programs if certain requirements are satisfied. A bona fide phased retirement program would permit a defined benefit or money purchase pension plan to make in-service distributions prior to normal retirement age. Employers have long been advocating this change in order to avoid retirement-eligible employees from terminating in order to receive a pension while working full-time or part-time for another company. A workable phased retirement program would enable employers to retain experienced employees without having to engage in the questionable practice of "rehiring" retirees as independent contractors.

However, the proposed regulation is very restrictive and imposes numerous administrative burdens upon employers that make it unlikely that this proposal will be the solution to this problem. Below is a list of the significant requirements that a phased-retirement arrangement must satisfy under the proposed regulation:

- The arrangement must be voluntary and only full-time and non-key employees who are at least 59½ years old may participate. Thus, not all retirement-eligible employees would be covered.
- An employee must reduce his/her hours of work by at least 20%.
- Benefits paid under a phased retirement program cannot exceed an employee's normal retirement benefit multiplied by the percentage an employee's hours are reduced. For example, an employee who reduces his hours by 25% could receive 25% of his normal retirement benefit. The Plan Administrator must make an annual determination to ensure that the work schedule used to determine a participant's phased retirement benefit is not materially different than the actual hours worked over the course of the year. This will be very difficult to calculate for salaried employees.
- Retirement benefits could not be paid in a lump sum. Since this is often the most popular option in plans that permit lump sums, this will discourage participation.
- Benefits must include applicable early retirement subsidies.
- An employee must be entitled to continue participation in the plan.
- The phased retirement program would be a separate optional form of benefit, subject to non-discrimination testing and protected by the anti-cutback rule. Thus, eliminating the

program, if determined not to be beneficial, would be difficult.

Plan sponsors may not rely on the proposed regulations at this time. This is a concept that is long overdue, and it is hoped that final regulations will ease some of the unfortunate restrictions to make phased retirement programs a more feasible option for all employers. We will update you when further guidance becomes available.

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