

# retirement

## plan news

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## Final 401(k) Regulations: An Overview for Plan Sponsors

The IRS issues regulations to provide taxpayers with guidance so they can meet the complex requirements of the Tax Code. On December 29, 2004, the IRS issued the long-awaited final 401(k) regulations, just in time for the beginning of the EGTRRA plan document restatement period.

These regulations incorporate a variety of pronouncements and law changes that have occurred since the 401(k) regulations were last updated in 1994.

The updated regulations are effective for plan years beginning on or after January 1, 2006. Plan sponsors *may* elect to apply the regulations to any plan year ending after December 29, 2004, as long as *all* of the applicable final regulations are applied. The IRS cautions that any plan considering mid-year adoption must comply with the final regulations for the entire plan year.

Following are some of the highlights of the final regulations that may have the most impact on plan sponsors.

### **Employers may not prefund elective deferrals or matching contributions.**

This means that employers may not make contributions on behalf of their employees until the employees have elected to have cash deferred from their paychecks and worked the requisite amount of time to earn the money. An exception is possible for a “bona fide administrative consideration,” a circumstance that might require contributions

to be deposited prematurely, such as a pay period when the company bookkeeper is going to be absent.

**The safe harbor list of expenses that qualify for hardship distribution** has been expanded. Funeral expenses and the cost of certain repairs to an employee’s principal residence (i.e., expenses that qualify for the casualty deduction, such as those resulting from hurricane or flood damage) now qualify for hardship distribution.

**Participants are no longer required to take a plan loan before taking a hardship distribution** if the maximum amount of the plan loan they qualify for doesn’t cover the hardship, or if taking the plan loan makes the hardship worse.

**The final regulations revise** and clarify the hardship definition of medical care. The regulations indicate that all deductible medical expenses — not just the amount that exceeds 7.5% of adjusted gross income — are to be used to satisfy



“a heavy and immediate need” for financial hardship.

**A change in status from employee to “leased” employee** is not regarded as severance when the employee continues to perform the same service for the

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# Final 401(k) Regulations: An Overview for Plan Sponsors *(Continued from page 1)*



same employer. Therefore, such an employee is not eligible for a plan distribution.

**After an employer terminates a 401(k) plan** and distributes all elective plan deferrals, the employer is permitted to establish certain “alternative defined contribution plans” without waiting 12 months. Currently, defined benefit plans, employee stock option plans (ESOPs), and SEPs are considered permissible alternative defined contribution

plans. Under the new rules, the list of permissible alternatives is expanded to include SIMPLE IRAs and 403(b) and 457(b) plans.

**In the event of an employer directed plan-to-plan transfer of assets**, the receiving plan must maintain the transferring plan’s restrictions on withdrawals of elective deferrals and qualified contributions.

**The final regulations confirm that certain deferrals** — specifically, catch-up elective deferrals by participants age 50 and older and deferrals by participants exercising their USERRA rights after returning from the military — are excluded from actual deferral percentage (ADP) testing.

**A safe harbor 401(k) plan may avoid testing** a discretionary match if the discretionary match does not exceed 4% of compensation and if the plan does not match deferrals above 6%. Under the new rules, all matching contributions that are exempt from discrimination

testing must be allocated in a non-discriminatory manner.

For example, say an employer makes a safe harbor matching contribution plus an additional discretionary matching contribution that includes an allocation restriction (such as a last-day rule or a 1,000-hours-of-service rule) and not all participants satisfy the restriction. Under the new rules, such an allocation would be discriminatory and, therefore, would not satisfy the safe harbor requirements. When the new rules take effect, safe harbor matching contribution plans may have to be amended to remove allocation restrictions. ❖

A table of safe harbor 401(k) formulas that ran in a prior issue contained an error. NOTE: A plan that provides a 3% nonelective safe harbor contribution, elective deferrals, a discretionary dollar-for-dollar match up to 3%, and no other employer allocations *would be exempt* from top-heavy testing.

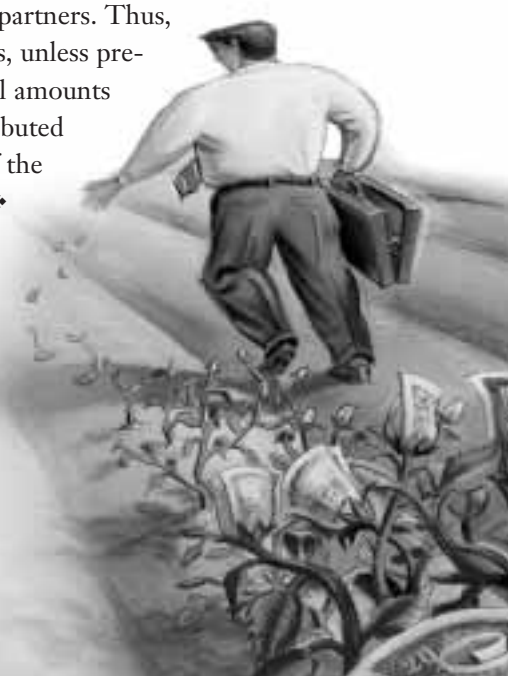
## Elective Deferrals for Sole Proprietors and Partners

The final 401(k) regulations from the IRS also address — and clarify — the timing of elective deferrals by self-employed individuals (sole proprietors or partners). The general deadline for the deposit of sole proprietors’ deferrals to the trust is their tax filing deadline plus extensions. However, self-employed individuals must complete a deferral election form declaring either the dollar amount or the percentage of income they wish to defer by the last day of the relevant tax year.

Self-employed individuals may elect to defer amounts during the year based on salary advances or draw *as long as* the total amount they defer does not exceed statutory limits — such as the Section 415 limit, which is based on the individual’s actual earned income for the period. The owner-employee also has to show a profit for his or her contributions to be valid.

According to guidance from the Department of Labor (DOL), the timing that applies to deposits of plan participant elective

deferrals does not apply to deposits of partner deferrals in a partnership plan *until after* the partnership would have otherwise distributed the amounts to the individual partners. Thus, in almost all cases, unless pre-funded, the actual amounts will not be contributed before the end of the applicable year. ❖



## Coverage Testing and the Coverage Transition Rule

Qualified retirement plans must meet many different requirements to retain their favorable tax advantages. For example, a plan is not qualified unless it satisfies minimum coverage rules. Generally, this means the plan must provide benefits to a sufficient number of the company's employees — in particular, the company's non-highly compensated employees or NHCEs.

There are two coverage tests: the ratio percentage test and the average benefits test. A plan must be tested every year and must pass one of the tests. If it cannot pass the simpler ratio test, it may try to pass the average benefits test. However, due to the complexity of the benefits test, many plans opt to amend their eligibility requirements to bring more NHCEs into the plan so it can pass the ratio test.

**The Ratio Percentage Test.** 70% is the “passing grade” for the ratio test. (We're focusing on the ratio test because the benefits test is beyond the scope of this article.) The ratio test requires several steps.

- The first step is to identify the “eligible” employees (i.e., those who are not legally excludable).
- Step two is to divide the eligible employees into highly compensated employees (HCEs) and non-highly compensated employees. Highly compensated employees are those who have an ownership interest of over 5% in the company and those who earned above a certain amount in the prior year. The income threshold for 2004 was \$90,000.
- Next, divide the number of NHCEs participating in the plan by the total number of eligible NHCEs to calculate the percentage of NHCE participation. And divide the number of participating HCEs by the total number of eligible HCEs to calculate the percentage of HCE participation.
- Finally, divide the NHCE percentage by the HCE percentage. If the result is 70% or greater, the plan passes the coverage test. If the number is less than 70%, the plan fails.

Let's use a medical practice with two doctors (HCEs) and ten additional employees (NHCEs) as an example.

### Situation #1:

If both doctors participate in the plan, the HCE ratio would

be 100%. If all ten NHCEs participate, the NHCE percentage would be 100%. The ratio of 100% divided by 100% would be 100%. The plan passes the coverage test.

### Situation #2:

If three NHCEs do not participate, the NHCE percentage would be 70%, which, when divided by the 100% for the HCEs, would be 70%. Again, the plan passes the coverage test.

### Situation #3:

If only six NHCEs participate in the plan, then it would fail the ratio percentage test since the NHCEs' 60% divided by the HCEs' 100% would be less than the 70% passing level.

### Situation #4:

If only one doctor participates, however, the HCE percentage would be 50%. The number of NHCEs participating could be as low as four — NHCEs' 40% divided by HCEs' 50% = 80% — and the plan would still pass the ratio percentage test.

**When Plans Combine.** If a merger or acquisition takes place and both companies sponsor qualified plans, special rules apply. Assuming the two plans passed coverage tests the day before the merger, there is a transition period during which the plans can pass separate coverage tests instead of having to test as a single entity, as long as there is no major change in benefits. The transition period lasts until the end of the plan year following the plan year in which the merger or acquisition took place.

If one of the plans *does* make a major change in the benefits it provides, then the transition rule ends at that time and the plans must be combined for coverage testing purposes. Depending on the results, the plans may — or may not — be permitted to operate separately. ❖



# recent developments

■ **Final IRS regulations** allow profit sharing and 401(k) plans that are not subject to the joint and survivor annuity rules to eliminate certain optional forms of benefit distributions. However, the final regulations do not include an earlier provision that provided plan participants with a 90-day waiting period after receiving a Summary of Material Modifications (SMM) announcing the change in benefit. The removal of this provision allows plans to immediately stop offering unwanted optional forms of benefit. However, the regular ERISA disclosure rules still apply to such plan amendments. Thus, the employer would still be obligated to issue an SMM within 210 days following the end of the plan year during which the amendment was adopted.

■ **The application period for EGTRRA plan documents has begun.** Though no action is immediately required on the part of employ-

ers reading this article, it is the start of yet another IRS restatement process, this time for the 2001 tax law known as EGTRRA. The IRS has announced that it is accepting applications for opinion and advisory letters for pre-approved defined contribution plans (master and prototype (M&P) and volume submitter (VS) plans) that are affected by EGTRRA requirements, the final required minimum distribution rules, and other changes in qualification requirements and guidance. The submission period for document providers for these plans ends on January 31, 2006.

■ **The IRS is introducing** a new six-year remedial amendment cycle for pre-approved plans and a staggered five-year cycle for individually designed plans. This means providers of pre-approved plans will only be required to submit applications for opinion or advisory letters once every six years, even though amendments may be

required before that time. The IRS will announce the next restatement deadline for pre-approved plans when it finishes the current plan document approval process. The deadline is expected to be approximately 2008.

■ **Proposals are in the works to strengthen the Pension Benefit Guaranty Corporation (PBGC).** Due to many large bankruptcies, the PBGC recently reported a record deficit of more than \$23 billion. Although the PBGC will be able to pay benefits for many years, rising deficits may undermine the PBGC's long-term financial solvency. The Bush administration is making proposals to reform the defined benefit and PBGC programs. It is focusing on three areas: reforming the funding rules to ensure pension promises are kept by improving incentives for adequately funding plans; improving pension plan status disclosures to workers, investors, and regulators; and increasing PBGC premiums. ❖

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