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Plan Loans Were Prohibited Transactions

situation: Joe was the trustee and administrator of his company's 401(k) plan. He also owned 100% of the company. Between 1996 and 1999, Joe made a series of loans totaling \$700,000 from the plan to three other companies in which he owned a minority interest. All of the loans were repaid on time with 12% interest — an above-market rate.

question: Were these loans prohibited transactions subject to excise taxes, as the Internal Revenue Service (IRS) contended, or permissible investments, as Joe maintained?

answer: They were prohibited transactions, according to the Tax Court.*

discussion: To protect plan participants, employers and other plan fiduciaries are held to high standards. They have to act in the interest of the plan, and they may not engage in self-dealing. Certain types of transactions are specifically prohibited. One type of prohibited transaction occurs when plan assets are used for the benefit of the employer sponsoring the plan or an individual who directly or indirectly owns 50% or more of the employer sponsoring the plan.

In the above situation, Joe owned the company that sponsored the retirement plan. But he still maintained that the loans were not prohibited transactions.

He argued that the loans were not a transaction between him and the plan and that he didn't benefit from them, either in the way of income or in the sense that his own plan account was enhanced. And he pointed out that the loans' interest rates were all above-market, the principal was repaid, and the plan assets were diversified.

In making its determination, the Tax Court looked at Joe's involvement in setting up the loans. As the 401(k) plan's trustee and administrator, Joe was responsible for investing, managing, and controlling the plan's assets. He made the decision to lend the plan assets and signed the loan checks from the plan to the borrower companies. Joe also signed the promissory notes on behalf of the borrowers.

In addition, even though Joe didn't personally receive any income or assets from the loans, he had derived a benefit from them because of his interests in the borrower companies. Because they were able to borrow from the plan, the companies did not have to deal with independent lenders.

As a result, the court held that the loans were prohibited transactions between Joe and the plan and that he had to pay prohibited transaction excise taxes and penalties for failure to file excise tax returns.

*Joseph R. Rollins, TC Memo. 2004-260

401(k) Testing and Eligibility Trends

situation: GoodCo recently hired a new manager who would like to roll over her retirement assets from her former employer's plan into GoodCo's 401(k) plan. However, GoodCo's plan has a one-year waiting period for participation. When GoodCo's owners set up the plan, they looked at the high turnover in their young work force and considered that new hires traditionally participate at lower rates than other workers. Then, they chose the maximum waiting period to make it easier for the plan to pass the actual deferral percentage (ADP) nondiscrimination test. Now, they're wondering if it's time for a change.

question: How do other 401(k) plans handle plan eligibility?

answer: According to a new survey released by the Profit Sharing/401(k) Council of America (PSCA),* over the past several years, the trend in eligibility waiting periods for both 401(k) plans and profit sharing plans has been toward allowing participation within three months of hire.

discussion: Under the tax law, an employer doesn't have to let an employee participate in a 401(k) until the employee reaches age 21 and has one year of service with the employer. Like GoodCo, many 401(k) plans created before 1999 chose the maximum one-year waiting period to increase their chances of passing the ADP test.

The ADP test determines the maximum amount of deferrals highly compensated employees can make to a

401(k) plan. The test compares the average rate at which highly compensated employees defer salary to the plan to the nonhighly compensated employees' average deferral rate. Differences in deferral rates between highly paid and lower paid employees must be within strictly defined limits.

Starting in 1999, though, plan sponsors have had a choice: They have been able to compare the ADP for all highly compensated employees who are eligible for participation with the ADP of *only* those eligible nonhighly compensated employees who have completed one year of service and reached age 21. (Certain other requirements must be met.)

Since this change, the PSCA has seen the percentage of 401(k) plans with eligibility waiting periods of three months or less increase from 32% in 1998 to almost 60% in 2004. In the same period, the percentage of profit sharing plans with waiting periods of

three months or less increased from 12% to 27%. Immediate participation (defined as within one month or less of hire) went from 24% to 42% for 401(k) plans and 9% to 18% for profit sharing plans.

The study noted some other patterns of eligibility practices for companies that sponsor both profit sharing and 401(k) plans.

- 57% use the same eligibility rules for both plans.
- 24% use a one-year waiting period for both plans.
- 16% have immediate eligibility for both plans.
- 16% have immediate eligibility for their 401(k) plan and a one-year waiting period for their profit sharing plan.

*401(k) and Profit Sharing Plan Eligibility Survey 2004, Profit Sharing/401(k) Council of America, www.pzca.org, psca@psca.org

How Long a Wait? (Percentage of Plans)		
	401(k) Plan	Profit Sharing Plan
Immediate Participation*	41.6%	17.5%
Three Months or 90 Days	16.4%	8.7%
Six Months or 1,000 Hours	12.3%	14.6%
One Year	22.7%	51.3%
Other	7.1%	7.9%

*Within one month or less of hire

Source: 401(k) and Profit Sharing Plan Eligibility Survey 2004, PSCA

Prohibited Transactions *continued from pg. 1*

comment: In an earlier decision, the Tax Court concluded that a plan loan to a company in which the plan's administrator had an 18% interest wasn't a prohibited transaction.** In that case, an independent trustee,

which had the exclusive right to make investment decisions for the plan, had approved the loan. The administrator was a plan fiduciary, but his authority and control were limited to making administrative decisions for the plan

(e.g., determining the eligibility for employees and maintaining records). Joe's authority was much broader.

** *Gaylord W. Greenlee*, TC Memo. 1996-378



It's a Take

With just days to spare, the IRS made good on its promise to finalize proposed 401(k) regulations by the end of 2004.* Because of these new regulations, 401(k) sponsors may have to make a number of changes in the way their plans operate.

What topics do the regulations address?

The regulations address a broad range of subjects, including:

- What constitutes a valid cash or deferred arrangement (CODA),
- What qualifies as an elective deferral,
- Hardship distributions,
- Actual deferral percentage (ADP) and actual contribution percentage (ACP) nondiscrimination testing,
- Gap period income on excess contributions, and
- ADP and ACP testing safe harbors.

The final regulations also place limits on providing qualified nonelective contributions (QNECs) on a "bottom-up" basis, sanction automatic enrollment of eligible employees who don't make an affirmative election, and prohibit prefunding of contributions — with a newly added exception.

What is the prefunded contribution exception?

An exception is provided for occasional contributions made before employment services are actually performed, provided the early contributions are made for bona fide administrative reasons and not with a principal purpose of accelerating the employer's tax deductions. Otherwise, elective contributions may be made only after the employee has performed the services that relate to the deferred salary.

What do the regulations say about automatic enrollment?

They confirm that a 401(k) plan can

specify that eligible employees will be automatically enrolled if they do not make an affirmative election whether or not they want to contribute to the plan.

Explain the limit on QNECs.

An employer whose 401(k) plan fails the annual ADP test for nondiscrimination can correct the failure by making additional QNECs for nonhighly compensated employees. Some employers have made a practice of targeting a small number of low-income participants to receive the QNECs (bottom-up leveling) in order to keep corrective contributions low. The new regulations generally require employers to limit each QNEC to no more than double the plan's "representative contribution rate" or 5% of the nonhighly compensated employee's compensation. For QNECs made to a plan subject to the Davis-Bacon Act or a similar law, the 5% limit is increased to 10%. Similar limits are placed on the use of targeted matching contributions to pass the ACP test.

Speaking of nondiscrimination testing, does a plan have to specify how it will satisfy the nondiscrimination rules?

Yes, under the new regulations, the plan document must specify how the plan will satisfy the nondiscrimination rules. A plan can do so simply by referencing the ADP test. But, where a choice of options exists (for example, the plan can use current year or prior year data), the plan must specify which option it will use. And safe harbor design plans must state whether safe harbor contributions will be nonelective or matching contributions.

How do the regulations affect hardship withdrawals?

The final regulations contain guidelines for determining (1) whether an employee requesting a hardship distribution has no other resources reasonably available to satisfy his or her immediate and heavy financial need and (2) the requirements for using the safe harbor test to determine whether a distribution is necessary to satisfy such a need. In addition, they add certain funeral and principal residence repair expenses to the list of qualified hardship expenses.

When do the new regulations take effect?

The regulations are effective for plan years that begin on or after January 1, 2006. This should give plan sponsors time to implement the extensive changes in plan operation that will be required. Plan sponsors can voluntarily apply the final regulations for plan years ending *after* December 29, 2004.

Will we need to update our plan?

Most likely. Many of the changes in the final regulations affect items that are specified in plan documents. The IRS has not yet indicated whether plan documents will need to be updated to reflect the changes prior to implementation or whether operational compliance will be sufficient.

This article highlights just a few of the provisions in the final regulations. You'll want to talk with us and your plan's legal advisor to determine what action needs to be taken to keep your plan in compliance.

*Federal Register, December 29, 2004

recent developments

In Benefit Plans

- **Be Ready for Rollovers.** New rollover requirements for automatically cashed-out accounts valued at more than \$1,000 but not more than \$5,000 take effect March 28, 2005. Recent IRS guidance (IRS Notice 2005-5) provides a sample good-faith amendment employers can use to add the new requirement. The notice also provides a grace period for employers needing more time to put appropriate administrative procedures in place.
- **403(b) Proposed Regulations.** After 40 years, the IRS decided it was time to revamp the 403(b) tax sheltered annuity regulations. The resulting proposed regulations, if finalized, would eliminate many of the differences between 403(b) and 401(k) plans.

For example, a 403(b) plan would have to be part of a written defined contribution plan with employee contributions made under a cash or deferred election, and contributions would have to be timely deposited, as is required of 401(k) plans.

- **Phased Retirement.** Employers in industries anticipating a shortage of qualified employees as baby boomers begin to retire *and* older employees who want to ease into retirement should take note. The IRS has issued proposed regulations that would allow defined benefit and money purchase pension plans to offer a phased retirement option. Basically, employees age 59½ and older could choose to cut their work hours and

receive a partial benefit based on the reduced hours. The preamble to the proposed regulations notes that profit sharing plans and 401(k) plans could provide for the same phased retirement rules or for other partial or full in-service distributions to be available to employees age 59½ and older.

- **Veterans Benefits.** The recently enacted Veterans Benefits Improvement Act of 2004 (VBIA) requires employers to post a notice of affected employees' rights and obligations under the Uniform Services Employment and Reemployment Rights Act of 1994. The U.S. Department of Labor is to provide the text of the required notice.

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