



Important Information

Plan Administration/Operation

May 2005

## Application of Final 401(k) and 401(m) Regulations To Governmental Plans

WHO'S AFFECTED These rules affect governmental 401(k) plans.

BACKGROUND AND SUMMARY On December 29, 2004, the IRS published final 401(k) and 401(m) regulations. For the most part, these regulations simply consolidate numerous pieces of official guidance that the IRS has issued since final 401(k) and 401(m) regulations were last published in 1991. However, these regulations also contain some new rules, which will require both plan amendments and changes to administrative procedures. This publication discusses some of the more notable changes and clarifications provided by these regulations as they apply to governmental 401(k) plans.

ACTION AND NEXT STEPS These final regulations apply to plan years beginning on and after January 1, 2006. Plan sponsors may choose to apply the new rules to any plan year ending after December 29, 2004. However, if *any* of the new rules is applied before the 2006 plan year, *all* of the new rules must be applied. As a result, plan sponsors that see a benefit in applying any new rule before 2006, must be careful to analyze the effect of applying all other new rules at the same time.

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## **Basic Plan Design**

### **Automatic Enrollment**

In prior guidance, the IRS had illustrated the automatic enrollment concept with examples that referred to automatic deferral percentages of 3% of compensation. These final regulations clarify that lower and higher default percentages are acceptable.

### **Ongoing Deferral Elections**

The final rules clarify that a plan must provide an “effective opportunity” for employees to make or change deferral elections at least once each plan year.

### **Contribution Pre-Funding**

In general, the final regulations provide that a contribution is considered to be a deferral contribution only if it is made after the employee has performed the services relating to the compensation from which the deferral is made. A similar rule applies to employer matching contributions. These new rules are designed to prevent private sector employers from pre-funding contributions in order to accelerate tax deductions and actually reverse the position the IRS took in Notice 2002-48.

An exception to these rules is provided to accommodate a bona fide administrative situation (for an occasional pay period only) that is not for the principal purpose of accelerating deductions. For example, the regulations mention the temporary absence of the employer’s bookkeeper who is responsible for transmitting contributions to the plan. No specific exception is provided for governmental employers that would not have any need to accelerate tax deductions.

## **Distributions**

### **In General**

Under these final rules, 401(k) deferral contributions may be distributed on account of:

- Death,
- Disability,
- Severance from employment,
- Age 59½,
- Hardship, or
- Plan termination.

### **Safe Harbor Hardship Withdrawals**

The final 401(k) regulations continue to provide safe harbor rules for determining if an employee has an immediate and heavy financial need (a “needs” safe harbor) and whether a distribution is necessary to satisfy an immediate and heavy financial need (an “amounts” safe harbor). In addition to the four safe harbor “needs” already established, the rules also include the following situations:

- Funeral/burial expenses for parent, spouse, child, dependent; and
- Repair of damage to employee’s principal residence that qualified for casualty deduction.

In addition, these rules clarify that the Working Families Tax Relief Act of 2004 (WFTRA) change in the definition of dependent does not apply to 401(k) rules permitting hardship withdrawals due to a dependent's medical, educational or funeral costs. Plan sponsors may ignore the WFTRA changes in 2005, despite existing plan document provisions that may incorporate them by reference, without having to amend plans to apply the new rules before 2006.

The revised rules also provide that a participant must request all other available plan distributions and loans, even if they would not be enough to satisfy the need. However, a commercial loan does not have to be requested if it would not be enough to satisfy the need.

### **Distributions at Plan Termination**

The final regulations continue to permit 401(k) plans to distribute deferral contributions at plan termination, but only if the employer does not maintain or establish an alternative defined contribution plan. Alternative plans do not include SIMPLE IRAs, 403(b) programs, or section 457 plans.

### **Impact of These Regulations**

These new and revised rules will have an impact on both plan documents and plan operation.

#### **Plan Documents**

Virtually all 401(k) plans will have to be amended to reflect these new regulations. However, the IRS has not indicated whether plans must be amended before the rules can be put into operation (i.e., by the end of the 2005 plan year). In addition, the IRS has not indicated whether it will provide model or sample plan amendments.

#### **Plan Operation**

As a result of these new regulations, a number of plan administrative procedures may need to be revised. For example, plans that wish to reflect the new safe harbor hardship withdrawal rules will have to revise their hardship withdrawal paperwork and procedures to reflect the new hardship circumstances.

#### **Next Steps**

Prudential Retirement is currently reviewing these rules and their impact on both the plan documents that we provide and our administrative procedures. We will contact you as we make changes to our administrative procedures to comply with these new rules. If you have questions about how these regulations affect your plan, please contact your Prudential Retirement representative.

#### **Pension Analyst by Prudential Retirement**

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