Comments to Internal Revenue Service on Retirement Plans

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Retirement Plans Cash or Deferred Arrangements Under Section 401(k) and Matching Contributions or Employee Contributions Under Section 401(m) Proposed Rule

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The American Society of Pension Actuaries (“ASPPA”) offers these comments in response to the Proposed Regulations on Cash or Deferred Arrangements (“proposals”) that were released on July 17, 2003.

ASPPA is a national organization of over 5,000 members who provide actuarial, consulting, administrative, legal and other services to sponsors of qualified plans.

The comprehensive proposals close the gap where no guidance previously existed and, in some instances, go a long way toward providing practical solutions to certain common operational situations. Other proposals, however, appear to increase the likelihood of compliance failures; therefore, clarification and further guidance is required for these aspects of the regulations.

SUMMARY OF ISSUES

These comments address ASPPA’s concerns with regard to a number of issues. This Summary of Issues is followed by a discussion of each topic together with a recommendation for improving the proposals.

1. Plans should not be required to calculate and distribute gap period income on refunds or reclassifications of excess contributions and excess aggregate contributions.

2. The proposals with regard to so-called targeted QNECs are too broad because they apply to flat-dollar allocations as well as Davis-Bacon plans.

3. Develop reasonable rules regarding the early deposit of deferral and matching contributions.

4. Guidance is needed stating when amendments to change elections affecting testing methods must be adopted.

5. Funeral expenses should be a “deemed” hardship withdrawal event.

6. Eliminate the rule that proposes no “default” language for the application of safe harbor rules or ADP/ACP testing.

7. Include guidance relating to application of the rules to USERRA contributions.

8. Safe harbor plans that terminate during the plan year should identify the “short plan year” with reference to the plan’s termination date.

9. Plan sponsors and plan administrators should be given the option to apply the final regulations at the earliest possible date.

10. Anti-abuse provisions should be eliminated from the final regulations.

DISCUSSION OF ISSUES

1. Plans should not be required to calculate and distribute gap period income on refunds or reclassifications of excess contributions and excess aggregate contributions.
In a departure from current guidance, the proposals connect the need to calculate and distribute gap period income on excess contributions and excess aggregate contributions (“corrective distributions”) solely with the timing of actual earnings valuations under the plan. This change has not been precipitated by any new legislation or any indications by Treasury that the current rules have produced problems or abuses.

Most plans sponsors have found the calculation of gap period income too burdensome and likely to cause an operational error and, therefore, as permitted under the current rules have opted to ignore gap period gain/loss. This choice is also a function of the manner in which plans operate today, often with compliance matters handled by a service-provider other than the party responsible for transaction-based activities of the plan. This division of responsibilities makes it difficult to ensure the timely distribution of correct amounts even when the safe harbor method of calculating gap period income pursuant to Reg. §1.401(k)-2(b)(2)(iv)(D) is used.

For example, suppose the corrective refund including gap period income is computed and communicated to the plan sponsor in September 2004; however, the paperwork required by the vendor to process the distribution is not submitted until December 2004. Regardless of the method of calculating gap period income under the proposals, the amount of the distribution is either too much (loss) or too little (gain) and, consequently, the plan has an operational violation.

Consider a situation where the testing failure requires the refund of $750 of an HCE’s deferral. The plan is valued daily. If the participant’s account experienced a 25% gain/loss, this translates into a $18.75 per month adjustment; a 10% gain/loss translates into a $7.50 per month adjustment, and a 5% gain/loss translates into a $3.75 per month adjustment. As noted, the adjustment could be a positive or negative adjustment but in any event the amounts are small. The consequences of an error in the distribution amount solely on account of the calculation of gap period income are clearly disproportionate to the administrative burden and associated costs to correct the error.

The proposals create an unnecessary trap for the unwary, produce the potential for more operational errors for small dollar amounts, and frustrate efficient plan operation for plan sponsors.

ASPPA Recommendation: The current rule under which the calculation and payment of gap period income on certain corrective distributions is permissive but not mandatory should be retained.

2. The proposed restrictions on targeted QNECs should not be applied to flat-dollar allocations or to required contributions under Davis-Bacon plans.

ASPPA recognizes that the use of targeted QNECs or QMACs (“QNECs”) can give rise to abuses. However, the proposals that attempt to eliminate the abuses are very complicated and overly broad, and the results have negative effects that go beyond the targeted QNECs mentioned in the Conference Committee Reports to EGTRRA.

ASPPA strongly contends that the proposals impose restrictions on flat-dollar QNECs that are inappropriate. The proposals suggest that a flat-dollar QNEC is discriminatory, a position that is not supported by regulatory history. It is widely accepted that giving the same dollar amount to each plan participant is, per se, nondiscriminatory. Treasury itself, in Reg. §1.401(a)(4)-2(b)(2), deems dollar-per-capita allocations as an inherently nondiscriminatory safe harbor allocation formula

In addition, a special issue arises under the Davis-Bacon and Service Contract Acts for plans that cover governmental contracts with several classifications of employees. Each classification of contract worker might require a different level of employer contribution to satisfy the contractual obligation. These contributions are generally treated as QNECs and are used in the ADP testing. The limit on "targeted QNECs" would impact the ability of plan sponsors to use these mandated contributions for testing, notwithstanding that the amount of the QNEC is not determined for any discriminatory purpose.

There are three reasons not to apply the targeted QNEC limitations to Davis-Bacon and Service Contract Act plans. First, the application of these rules unreasonably complicates the calculation of the ADP/ACP testing, requiring the plan administrator to determine the permissibly includable QNEC from a range of contractual contribution amounts. Second, there is no policy reason to deny the use of the QNECs in ADP/ACP testing, as they are not made in response to a failed ADP/ACP test, but as a result of the contractual obligations of the employer. Finally, the employer is not permitted to make contributions in addition to the contractual amounts on behalf of the employees, even if it would choose to do so in order to permit higher deferrals by HCEs. Therefore, the company cannot do anything to ameliorate a failed test, other than to refund deferrals to the HCE group.

ASPPA Recommendation: The proposals should be modified to:

- Exempt flat-dollar QNEC allocations from these rules.
- Exclude contributions treated as QNECs to Davis-Bacon or Service Contract Act prevailing wage arrangements from the limitations.

3. The proposals relating to the timing of deferrals and matching contributions are overly restrictive and unnecessary to remedy the IRS concerns about early deductions of deferrals.

The proposals prohibit the contribution of elective deferrals prior to the end of the period for which the related services are rendered or, if earlier, the date on which the deferral would otherwise be available to the employee. ASPPA understands that the genesis of this rule is the improper practice by some plan sponsors of pre-contributing and deducting deferrals and matches at the end of one fiscal year in relation to compensation earned and services performed in the following fiscal year. This is a legitimate concern. However, the proposals go well beyond the abusive situations addressed in Notice 2002-48 and Revenue Rulings 90-105 and 2002-46 and prohibit common practices that benefit participants.

Plan sponsors face prohibited transaction penalties from the Department of Labor if the deposit of salary deferrals to the trust is deemed to have occurred too late. To ensure that DOL's rules are met, some plan sponsors may deposit deferrals and the related matches a few days before the payroll date. Under the proposals, the employer would be required to treat these early deposits as employer non-elective contributions.

Often, contributions are made early when the person responsible for payroll knows that he or she will not be in the office on a payroll date. For example, a payroll person leaving on vacation may make an early deposit of payroll taxes with the government and salary deferrals and matching contributions with the fund-holder to avoid late payment while he or she is out of the office. The motivation here is not to gain any tax advantage but rather to ensure that these amounts are not paid late.

Another issue that occasionally surfaces is that the amount deposited with respect to an employee is overstated. To correct this administrative error, the plan administrator will allocate a "negative" contribution and adjust the next plan deposit. Under the proposals, this so-called negative contribution would be treated as a nonelective contribution to that participant's account.

The proposals also raise concerns with regard to the manner in which many partners or other self-employed participants make elective deferrals. It is common for such self-employed participants to have elective deferrals reduce their periodic draw or guaranteed payment. The guidance reiterates the long-standing principle that a self-employed person's income is treated as received on the last day of the plan year; therefore, the proposals – if left unchanged - would cause such contributions to be classified as nonelective contributions rather than elective deferrals.

These examples illustrate common administrative practices that are intended to comply with the existing rules rather than give any special tax or investment advantage to the plan sponsor or its employees. Deferrals and employer matching contributions should be deductible in a given tax year only if the deferrals and match relate to services to be performed or compensation to be paid in such year. If the amounts relate to performance of services or compensation payments in a later tax year, the amounts would be deductible in that year. Furthermore, under current law, such treatment would cause the deposits not to be tax deductible in the year of deposit, invoking the application of the excise tax under §4972 for nondeductible contributions. This existing tax treatment and excise tax are sufficient to deter unnecessary early contributions and deductions.

ASPPA Recommendation: A reasonable rule would provide that, for purposes of applying §404, elective deferrals and matching amounts contributed to the plan during the employer's taxable year are deductible for such year only if they relate to compensation otherwise earned or paid no later than the last day of such taxable year.

4. Guidance is needed regarding when amendments to testing methods must be adopted.

The proposals do not address the time by which an employer must adopt plan amendments to change from prior year testing to current year testing or vice versa (or similar testing-related changes).

IRS officials have correctly pointed out that an amendment to nondiscrimination testing methods could violate §411(d)(6) anti-cutback rules if the change in testing procedure can decrease QNECs that were otherwise allocable to NHCEs or if the amendment modifies the group to whom the QNECs are allocated. ASPPA agrees that an amendment that would limit or lower the amount of QNEC or QMAC allocated to an NHCE should be adopted prior to the end of the plan year for which it is effective. However, an amendment will not raise §411(d)(6) issues if the sole impact of the amendment is to reduce the amount of refunds to the HCE group and, therefore, it should be permissible to adopt the amendment at any time during the §401(k) testing correction period ending 12 months after the end of the testing year.

ASPPA Recommendation: The date by which amendments to change testing options must be adopted should be linked to the impact, if any, on allocations to NHCEs; however, in no event (other than through an approved EPCRS correction) should amendments to testing elections be made later than 12 months after the close of the plan year to which it relates.

5. Funeral expenses should be included in the list of "deemed" hardship events.

Funeral expenses are cited as an example of a bona fide hardship in both the existing and proposed regulations. [See Treas. Reg. §1.401(k)-1(d)(2)(iii)(A), Prop. Reg. §1.401(k)-1(d)(3)(iii)(A).] However, such expenses are not included as a "deemed" hardship under Treas. Reg. §1.401(k)-1(d)(2)(iii)(B) or Prop. Reg. §1.401(k)-1(d)(3)(iii)(B). In the recent final regulations to §457, funeral expenses became a permissible reason for a distribution due to unforeseen emergency from an Eligible Deferred Compensation Plan. Treas. Reg. §1.457-6(c)(2)(i). These rules should be consistently applied to both §457 plans and §401(k) plans.

ASPPA Recommendation: Funeral expenses for a participant's spouse or dependents should be added to the list of deemed hardship events.

6. A plan that fails to meet the requirements of the safe harbor rules under §401(k)(12) and/or §401(m)(11) should be permitted to utilize ADP/ACP testing if the plan document so provides.

The proposals provide that it is impermissible for a plan to state that, in the event that the safe harbor provisions of §401(k)(12) and/or §401(m)(11) are not met, the plan will revert to ADP and ACP testing to show nondiscrimination.

Plans have been approved in the GUST restatement process that contain provisions permitting the application of the safe harbors in such years as the employer meets the requirements. Therefore, the position expressed in the proposals represents a departure from current practice. This departure is not mandated by the Code, which requires only that the cash or deferred arrangement meet the contribution and notice requirements. In fact, the very title of §401(k)(12)(A) ("Alternative Methods of Meeting Nondiscrimination Requirements") contemplates that this is one means by which the employer can comply with the Code as an

alternative to ADP/ACP testing.

This proposal interferes with a common and reasonable practice under provisions that are present in documents that have been the subject of favorable determination letters. Many pre-approved and individually-designed documents provide that a plan will operate as a safe harbor plan for a plan year only if notice is given to participants within a reasonable period prior to the beginning of the plan year. In this manner, the document itself uses the timely delivery of the notice as a trigger for when the safe harbor provisions apply to the plan. If notice is not properly given, the safe harbor provisions with respect to nondiscrimination testing are inapplicable and the ADP/ACP nondiscrimination testing is performed for such year. Prohibiting such "default" plan provisions will simply be a potential disqualification trap for no apparent policy reason.

ASPPA agrees that, depending on the terms of the plan, the plan sponsor may still be required to make contributions at the same level as though the plan continued as a safe harbor plan. For example, the 3% nonelective contribution or 4% matching contribution may be required even though the plan is not a safe harbor plan that year for purposes of nondiscrimination testing. In other words, the plan sponsor must take action before the start of the plan year if it intends to remove such provisions or be liable for such contributions to the extent those amounts are required under the terms of the plan.

ASPPA Recommendation: Remove from the proposals the requirement that plans not be able to "default" to ADP/ACP testing.

7. The final regulations should address how make-up elective deferrals and related matching contributions pursuant to USERRA are treated for testing and other limitations purposes.

On August 6, 2003, ASPPA submitted a letter requesting guidance on the application of USERRA to §401(k) contributions. That letter contained recommendations in relation to the make-up deferrals and related matching contributions deposited to a plan in accordance with USERRA.

ASPPA Recommendation: Guidance with respect to make-up contributions under USERRA should be included in the final §401(k) regulations.

8. The definition of the "final plan year" should be clarified as it applies to the proposals under §1.401(k)-3(e)(4).

The proposals provide that a safe harbor plan will continue to qualify under §401(k)(12) and/or §401(m)(11) in a short plan year if the short year is a result of a plan termination. When a plan sponsor terminates a plan, deferrals and other contributions cease at the date of termination but the plan continues to be in effect during the "wind down" process while the plan sponsor finalizes distribution documentation and, perhaps, applies to IRS for a letter of determination with respect to the plan's termination.

The proposals do not make it clear that the plan's safe harbor status in the year of termination is not adversely impacted if the plan continues to exist beyond the date of the plan termination. In addition, final regulations should make it clear that safe harbor contribution obligations are met if such contributions are made only with reference to compensation and deferrals during the period for which the plan was active.

ASPPA Recommendation: Final rules should clarify that the length of the "final plan year" is determined by reference to the plan's termination date for purposes of §1.401(k)-3(e)(4). The short plan year rule should relate only to the period the plan is active.

9. Plan sponsors and plan administrators should be given the option to apply the final regulations at the earliest possible date.

The preamble to the proposals indicates that the final regulations may permit sponsors to implement the final regulations for the first plan year beginning after publication. Certain provisions of the proposals provide guidance where none existed or, alternatively, ease plan administration and compliance. For this reason, it is important that the final regulations permit application upon issuance rather than only upon the otherwise applicable regulation effective date.

ASPPA Recommendation: The final regulations should contain a rule permitting plan sponsors or plan administrators to elect immediate application of the rules, as currently stated in the preamble to the proposals.

10. The anti-abuse provision in the proposals should be removed.

The regulations include very broad, general, anti-abuse language, permitting the IRS to disqualify plans that have repeated changes to testing or plan provisions intended to manipulate the nondiscrimination results. This type of broad “catch-all” language impairs the certainty that the regulations seek to attain by having bright line, objective testing. The proper remedy available to the IRS for an abusive situation is to issue guidance addressing the abusive practice. This avenue should be pursued rather than the “catch-all” provision in the regulations.

ASPPA Recommendation: The anti-abuse provision should be deleted from the final regulations.

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The proposals reserve §1.401(k)-5 and §1.401(m)-4 for special rules for mergers, acquisitions and similar events. ASPPA intends to submit a request for guidance on specific issues under these sections in the near future.

This letter was prepared by the ASPPA’s §401(k) Subcommittee of the Government Affairs Committee. The primary authors were Robert Kaplan and Ilene Ferenczy of the §401(k) Subcommittee and Sal Tripodi of the Legislative Relations Committee. Please contact us if you have any comments or questions regarding the matters discussed above.

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