ROBINSON & COLE LLP
Employee Benefits & Compensation

IRS Issues Final 401(k) Regulations

The IRS has issued final regulations on employee salary deferrals, after-tax contributions and employer matching contributions under 401(k) plans. The regulations are very similar to the proposed regulations issued in 2003.

• **Hardship Withdrawals**. Funeral expenses and expenses necessary to repair damage to a principal residence have been added to the list of situations that can be deemed an immediate and heavy financial need. The regulations clarify that Section 213 medical expenses will be deemed an immediate and heavy financial need regardless of whether they exceed 7.5% of the participant's adjusted gross income. The regulations also clarify that the recent changes to the definition of dependent under Section 152 of the Code can be ignored in determining whether an employee is entitled to a hardship withdrawal for post secondary educational expenses.

• **Testing Method Provisions**. The regulations require a plan document to specify the testing method used to satisfy the nondiscrimination tests. The regulations allow a plan to use prior year testing for either the ADP or the ACP test and to use current year testing for the other test. The regulations provide that a plan will be treated as failing the nondiscrimination tests if there are repeated changes to testing methods or manipulation of the nondiscrimination testing rules.

• **Gap Period Income**. Gap period income is the earnings between year-end and the date that the corrective distribution is made. The final regulations require gap period income to be included in any corrective distribution if the participant's account would have been credited with income had the entire account been distributed. A plan is permitted to disregard gap period income for a period of up to seven days (such as from the date of recalculation to the date of distribution).

• **Targeted QNECs and Matching Contributions are Limited**. Consistent with the proposed regulations, the ability of plan sponsors to use bottom up qualified non-elective contributions (QNECs) and qualified matching contributions to assist in passing the ADP and ACP tests is significantly restricted.

• **Aggregation**. Employers can now elect whether or not to aggregate the ESOP and the non-ESOP component of a 401(k) plan for ADP and ACP testing purposes. However, the ESOP portion of a plan still must be tested separately from the non-ESOP portion of the plan for purposes of the minimum coverage requirement.

• **Prefunding Prohibited**. As under the proposed regulations, employers are prohibited from prefunding contributions in order to accelerate the employer tax deduction.

The final regulations apply for plan years beginning on or after January 1, 2006. Any necessary plan amendments must be adopted before the end of 2006. An employer can amend its plan to implement the regulations before 2006 if the plan complies in all respects with the regulations and if the regulations are applied for the entire plan year.

IRS Issues Final Regulations Permitting Plan Sponsors to Eliminate Distribution Options Under Defined Contribution Plans

The IRS has issued final regulations allowing plan sponsors to eliminate some distribution options offered under a defined contribution plan. A defined contribution plan can be amended to eliminate a method of distribution provided that participants have the ability to elect an equivalent lump sum distribution option. Consistent with the proposed regulation, the final regulations eliminate the requirement that a plan sponsor provide participants with 90 days notice of the plan amendment.

Any amendment eliminating an optional form of distribution cannot apply to distributions that have already begun. Plan sponsors that amend their plan to eliminate distribution options should include this information in a summary of material modification or a summary plan description. The final regulations are effective January 25, 2005.

Directed Trustee Did Not Breach its Fiduciary Duty

In the case of In re WorldCom Inc. ERISA Litigation, the U.S. District Court for the Southern District of New York ruled that Merrill Lynch, a directed trustee of WorldCom's 401(k) plan, did not possess nonpublic information about WorldCom, and therefore did not breach its fiduciary duty by failing to remove WorldCom stock as a plan investment. However, the court indicated that all fiduciaries, even directed trustees, have a duty to continually monitor plan investments.

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