PCS Compliance Alert

Fall 2005

IMPORTANT QUALIFIED PLAN CHANGES FOR 2006 (FALL 2005, PART I)

As summer winds to a close, this issue of the Alert focuses on the first of two significant changes impacting retirement plans for plan years beginning in 2006, **the new final 401(k) regulations**. The Alert also addresses **the new rules limiting deferrals of post-termination pay**. In addition, the Alert follows important developments concerning **nonqualified deferred compensation plans**. Finally, the Alert includes a brief overview of the subject of Part II of the Fall Compliance Alert to be published in the next few weeks: **the new Roth 401(k) and 403(b) rules**.

NEW 401(k) REGULATIONS LIMITING FLEXIBILITY MUST BE COMPLIED WITH FOR PLAN YEARS BEGINNING IN 2006

After years of significant statutory change and patchwork regulatory guidance, the Internal Revenue Service ("IRS") has consolidated the expansive body of rules for 401(k) plans into a single set of new final regulations effective for plan years beginning on or after January 1, 2006 ("Regulations"). While the focus of the Regulations is the consolidation of prior guidance, the Regulations also institute some very significant new rules, including the following:

Prefunded & Targeted Contributions Banned

The Regulations eliminate two practices that the IRS views as "abusive" - prefunding and targeted contributions. "Prefunding" involves making contributions to a 401(k) plan before the employee earns the compensation subject to deferral, in order to accelerate the employer's tax deduction and permit more employee tax-deferred earnings. The Regulations retain the proposed rule that contributions may not be deposited into the plan before the employee has earned the underlying compensation, unless there is some occasional bona fide administrative reason to do so (e.g., the plan sponsor's payroll person is going on vacation). The Regulations also clarify that the new rules regarding the timing of contributions are not intended to prevent self-employed individuals or partners from deferring amounts that are paid to them throughout the year on account of services performed during the year based on advanced salary or "draw," although income is not finally determined until the last day of the year.

"Targeted" (or "bottom-up leveling") employer contributions are often used by plans that fail the nondiscrimination test as an alternative to distributing the excess to highly compensated employees (HCEs). Specifically, they are additional employer contributions made first to the employees with the lowest compensation. Under this method, small contributions result in a large percentage of deferral for such lower-paid employees, enabling the plan to pass the nondiscrimination test at a relatively small cost. Generally, the Regulations provide that employer contributions can only be used if they are made on a uniform basis to all non-HCEs (NHCEs). There is an exception for employer contributions to an NHCE that do not exceed 5% of compensation. Employer contributions to an NHCE that exceed 5% of compensation can be taken into account under for testing only if additional requirements are met.

New Guidance on Safe Harbor Plans

The Regulations also incorporate detailed guidance on safe harbor plans, which require a minimum level of either matching or nonelective employer contributions to exempt the plan from nondiscrimination testing. In addition, the Regulations make safe harbor plans more attractive to employers by providing more flexibility. For example, the Regulations clarify that a plan that begins the year as a safe harbor plan can be amended to eliminate the safe harbor match, if necessary, and conversely that a plan can, in some cases, be amended to add a safe harbor provision up to 30 days prior the end of the year.

Changes Regarding Hardship Distributions

The Regulations also make the following changes for hardship distributions: (i) shorten the period of employee suspension from making elective contributions after a hardship distribution from one year to six months; (ii) clarify that the plan may rely upon the employee's written representation that he or she has no other sources of funds to meet the hardship (unless the plan administrator has actual knowledge that the representation is false); (iii) provide that the employee need only represent that he or she cannot obtain a commercial loan in the full amount necessary to meet the hardship, and need not agree to obtain such a loan if one is not available on reasonable commercial terms; and (iv) add funeral expenses and certain expenses relating to the repair of damage to the employee's principal residence to the list of events that constitute immediate and heavy financial need.

Approval and Clarification of Automatic Enrollment Plans

The Regulations explicitly approve the use of automatic enrollment in a plan and allow the plan to treat participants as having elected a basic contribution level, unless they affirmatively opt out. The final regulations clarify that the 3% default deferral percentage set forth in Rev. Rul 2000-8 was merely an example and that the plan may specify a different percentage. Please note, however, that the U.S. Department of Labor ("DOL") has taken the position that an employee will not be treated as having chosen the default investment option under a plan just because the employee does not make a different election. This underlies the necessity of providing for prudent investment of the accounts of employees who do not make their own investment election. The preamble to the Regulations also contains a footnote about a DOL advisory to the Treasury concerning ERISA 404(c), indicating that the DOL's view is that a participant will not be deemed to have exercised control over the investments merely by being informed of the investments selected in the absence of contrary instructions, so the fiduciary will not be considered to be relieved from investment liability in that case.

Gap Period Earnings

The Regulations provide that earnings on corrective distributions of nondiscrimination testing failures during the period between the last day of the subject plan year and the date of distribution ("gap period income") must be distributed if the Plan credits such gains or losses on such amounts (that is, when the plan is a daily valuation type). Previously, there was no requirement to distribute such amounts. The final regulations do allow the exclusion of income earned on corrective distributions for a period of not more than 7 days prior to the date of distribution from such distribution amount.

Effective Date and Compliance

A 401(k) plan may voluntarily subject itself to these new regulations prior to January 1, 2006, but then no "cherry picking" is allowed - that is, all of the new rules are effective in 2005 including the new restrictions on bottom-up leveling as well as new standards for hardship withdrawals and permissible mid-year safe harbor plan modifications.

What to Do Now

As a result of this "all or nothing" approach, it appears that the majority of plans have shied away from incorporating these 401(k) rules changes until required to do so for 2006. The IRS has not yet issued guidance on when plans are to be amended to reflect the changes of the final regulations. We will update you on the timing for plan amendments once guidance is issued. However, you should anticipate the need to adopt a plan amendment sometime early in 2006 that incorporates most of the changes described above that are applicable to your plan.

IRS Allows 401(k) Deferrals of Certain Post-Severance Compensation

Recently issued proposed regulations include important new guidance concerning salary deferral programs such as 401(k) plans, 457(b) plans and 403(b) plans. The regulations (issued under Section 415 of the Internal Revenue Code of 1986, as amended (the "Code")) represent an attempt to clarify a long-standing gray area of the law: **Can deferrals be made against post-termination of employment pay?** The answer is "yes," but only with respect to specified forms of post-severance compensation.

Specifically, the proposed regulations generally permit elective deferrals from short-term post-severance compensation paid within 2½ months after severance from employment if: (i) absent a severance from employment, employees would have earned such payments as regular compensation for services performed during their regular working hours or in a form of compensation such as overtime, a shift differential, commissions or bonuses; or (ii) such payments are for accrued bona fide sick, vacation or other leave that employees could have used had they remained employed. Deferrals may not be made from any other post-severance payments, regardless of when they are paid. For example, deferrals may not be made from severance pay, unfunded non-qualified deferred compensation or parachute payments. There are also special rules that apply to employees in military service who receive continued compensation from their employers or differential pay (the difference between regular pay and military pay).

While the proposed 415 regulations are generally not effective until 2007, the post-severance compensation portion may be relied upon now, **and at least one IRS official has even informally indicated that these rules are intended to be effective retroactively as of January 1, 2005.**

What to Do Now

Despite an earnest attempt to resolve years of confusion, additional IRS guidance in this area remains necessary, for example, more precise examples of the types of compensation covered would be helpful as would clarification with regard to the effective date of the new rules. While most sponsors of 401(k) and other plans with cash or deferred elections will welcome the new deferral possibilities, they may need to modify their payroll systems to distinguish between different types of compensation, such as regular paychecks received after severance and post-employment severance plan benefits, before they can permit such deferrals. We will keep you apprised of further developments, especially, the IRS' interpretation of the effective date of these new rules.

IRS Proposed Regulations on Nonqualified Deferred Compensation Expected in the Next Few Weeks

The New Deferred Compensation Rules

As part of the American Jobs Creation Act of 2004, the Code was amended to curb perceived abuses in nonqualified deferred compensation. Among its numerous provisions, Section 409A effectively restricts the timing of deferrals and the timing and form of payments, eliminates "haircut" provisions (i.e., deferred amounts being made available to an executive at all times, but subject to a penalty, e.g., 10% of the distribution), limits acceleration of payments (e.g., no acceleration based upon company financial health triggers), eliminates company discretion as to the timing and form of benefits, restricts the use of offshore trusts to house deferred compensation assets, limits permissible distribution events, re-defines the term "disability" for permissible plan distribution purposes and eliminates the use of rolling risks of forfeiture (that delay taxation of deferrals by pushing back vesting to a later date on a schedule selected by the participant) and prohibits the use of covenants not to compete as constituting a substantial risk of forfeiture of benefits so as to prevent current taxation. In particular, deferral of compensation elections must be made by the end of the year preceding the year during which the compensation for services is earned.

For example, deferral elections for compensation for 2006 services must be made by December 31, 2005. If contingent performance-based compensation is involved, the deferral election must be made no later than 6 months before the end of a performance period that is at least 12 months long. There are grandfather exceptions for older vested benefit amounts, but the new rules were generally effective with respect to deferred compensation as of January 1, 2005.

Special Tax- Exempt Employer Issues

Of particular import to tax-exempt employers is that the Section 409A guidance issued to date states that Section 409A overlays, and operates simultaneously together with, Code §457(f). Therefore, "noneligible" 457(f) plans that are typically used to provide "top-hat" deferred compensation benefits for executives of tax-exempt employers are covered by Section 409A. This necessarily means that the deferral and payment timing rules of Section 409A, along with the other numerous requirements of these new rules, apply to the nonqualified deferred compensation plans of tax-exempt employers, although how they coordinate with Section 457(f) is not especially obvious at this juncture. Particularly critical is that many of these tax-exempt employer deferred compensation plans have long relied upon covenants not to compete to delay current taxation and, apparently, IRS tax-exempt organization examiners on audit recently have been disallowing the use of these provisions and imposing sanctions or requiring plan restructuring. In addition, the use of rolling vesting to delay immediate taxation has also received much attention from these IRS examiners, also raising concern over the possible disallowance of such provisions as tax deferral mechanisms. (The IRS has viewed rolling vesting warily for years, even before the addition of Section 409A, although unilateral extensions of vesting periods, typically, for 2 years with 6-12 months advance notice, have been upheld.)

Notice 2005-1 Transitional Guidance

The IRS guidance issued thus far does provide exceptions for certain types of payments (partnership interests and certain stock/equity compensation awards), as well as, transitional relief rules (for severance payments and contingent performance-based bonuses) and an opportunity to amend for compliance or terminate plans or payment elections by the end of 2005. For example, certain arrangements are not treated as subject to Section 409A. If benefits are paid out within a short period of time following the year during which vesting occurs (the "2½ month short-term deferral" rule), Section 409A is inapplicable. In light of this new level of IRS scrutiny, it is important for employers to act in a timely manner in the case of Section 409A because noncompliance can result in the imposition of immediate taxation of deferrals, a 20% of income inclusion penalty, plus deemed late payment interest. Furthermore, Notice 2005-1 also imposes new reporting and disclosure requirements with respect to nonqualified deferred compensation that are effective as of 2005.

What to Do Now

Hopefully, the anticipated proposed regulations will provide substantially enhanced guidance in this area. Regardless of the issuance date of the proposed regulations, it is important for employers during this interim period to begin the process of reviewing deferred compensation programs for Section 409A compliance and possible modification, particularly in light of the new focus on tax-exempt employer audits and because the IRS has also undertaken an extensive examination program for executive compensation in the for-profit employer world, which, apparently, will also significantly focus on Section 409A compliance beginning in 2007.

Additional guidance has been promised in the form of proposed regulations due out in Fall, 2005. Again, it would behoove all employers to begin the process of reviewing all executive deferred compensation agreements, as well as severance programs, performance bonus programs, nonqualified stock options, stock appreciation rights (SARs) and all other arrangements including,

but not limited to, executive employment agreements, that fit within the broad ambit of the definition of deferred compensation that the IRS has adopted in this regard in order to ascertain where amendments may be necessary. Notice 2005-1 does provide the opportunity for plans to terminate or for new elections to be made without penalty under Section 409A during 2005 and it is possible that the proposed regulations will expand upon that transitional relief. In any event, employers should start the process of having employees make deferral elections for 2006 (unless a contingent performance-based bonus is concerned). We will keep you advised.

Roth 401(k) and 403(b) Plans

A New Concept

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) introduced the novel concept of a Roth 401(k). Adding a Roth component to an existing cash or deferred plan would permit after-tax contributions to be made to a 401(k) plan (or Roth 403(b) plan). Proposed regulations on the Roth 401(k) were issued earlier this year that addressed certain operational issues. In the 401(k) realm, such contributions would be treated like pre-tax 401(k) contribution for plan testing purposes, but the contributions and earnings thereon would escape taxation, if distribution is made under the same limitations that apply to a Roth IRA: after attainment of age 59 ½ or death or disability and only after 5 years have elapsed from the taxable year of the initial Roth 401(k) contributions. (There are special rules that apply to rollover amounts.) Unlike a Roth IRA, there are no income limitations on an individual funding a Roth 401(k). (There is a $150,000 compensation limit that prevents a joint federal income tax filer from funding a Roth IRA).

Why This Arrangement May Be Attractive

Roth 401(k) accounts may be rolled over into Roth IRAs upon a distribution event, and unlike a Roth 401(k) plan, a Roth IRA is not subject to required minimum distribution rules during the Roth IRA owner's lifetime. (The required minimum distribution rules require that benefits generally must commence as of the tax year when the IRA participant turns age 70 ½). In essence, a Roth 401(k) balance can be rolled over to a Roth IRA in order to avoid such mandatory required minimum distributions, seemingly a very effective technique to pass on an income tax-free sum to heirs while avoiding lifetime distributions.

What to Do Now

Many questions remain, however, that were not answered in the proposed Roth IRA regulations including what type of enabling language must be added to the plan document and the timing of required plan amendments. Therefore, everyone interested in this new concept is eagerly awaiting additional IRS guidance anticipated in the next few weeks.

Anticipating issuance of the final regulations, employers many want to begin to think about whether adding a Roth feature makes sense based upon the subject plan's particular demographics. In any event it appears that these opportunities to defer after-tax amounts will benefit both highly compensated employees who can use this mechanism as an estate planning tool when the Roth IRA is unavailable due to the compensation cap limits, and also lower-paid employees who would have otherwise potentially faced income taxes on 401(k) earnings in a higher tax bracket upon distribution. One troubling prospect is that absent an extension by Congress, the Roth programs are set to expire in 2010 so there is some level of uncertainly as to the long-term prospects for these programs.