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Internal Revenue Service Issues Proposed Regulations for Automatic Contribution Arrangements

Although 401(k) plans are the most popular form of tax-qualified deferred compensation plan, a problem area for some clients is the special nondiscrimination testing rules, which limit the elective contributions and matching contributions for highly compensated employees (for 2008, a highly compensated employee is an employee whose compensation exceeds $105,000). Under one test - the actual deferral percentage or ADP test, the average percentage of compensation deferred for highly compensated employees is compared annually to the average percentage of compensation deferred for nonhighly compensated employees eligible to participate in the plan. If certain limits are exceeded by highly compensated employees corrective action must be taken, the most common form of which is a distribution to the highly compensated employees. There is a parallel test for matching contributions and after-tax contributions called the actual contribution percentage or ACP test.

Several years ago, Congress provided some relief for employers who were experiencing testing problems by providing a design based safe harbor under which elective deferrals and any associated matching contributions are treated as satisfying the ADP and ACP tests if the arrangement satisfied certain contribution and notice requirements.

For plan years beginning after January 1, 2008, the Pension Protection Act of 2006 ("PPA") added an alternative design based safe harbor for a 401(k) plan that provides automatic contributions at a specified level of contributions and satisfies certain contribution, notice and other requirements. The PPA also provided further relief for these automatic enrollment plans by relaxing the strict distribution standards under 401(k) plans. For example, prior to the PPA if a plan provided for automatic enrollment, a common occurrence would be that an employee, who realized after a few payroll cycles that amounts were being taken from his/her paycheck, would not want to continue. So far, so good - except that the employee would also want to receive back the 401(k) deferrals that were deducted from his/her pay and contributed to the plan. Unfortunately, prior to the PPA, absent circumstances giving rise to a hardship withdrawal or the participant's attaining age 59½, these amounts were locked in under the 401(k) plan.

Under the PPA, a 401(k) plan that has an eligible automatic contribution arrangement ("EACA") may allow employees to receive a distribution equal to the amount of the elective contributions (and attributable earnings) made with respect to the employee beginning with the first payroll period to which the EACA applies and ending with the effective date of the election to discontinue participation in the 401(k) plan. The election must be made within 90 days after the date of the first elective contribution and the amount of the distribution is includible in gross income for the taxable year within which the distribution is made. For these purposes, EACA is an arrangement under which:

- a participant may elect to have the employer make contributions to the plan on behalf of the employee or the employee may receive them in cash;

- absent an election, the participant is treated as having made an election equal to a uniform percentage of compensation, until the employee specifically elects not to have such contribution made (or specifically to have such contributions made at a different percentage);

- absent an investment election by the participant, such contributions are invested in accordance with the DOL qualified default investment arrangement ("QDIA") regulations; and

- the participant receives a statutory notice.

While the safe harbor approaches are similar in a number of respects, there are also some important differences. For example, the matching contribution requirement for a qualified automatic contribution arrangement is less than for the other design based safe harbor and the vesting schedule is also slower - full vesting after two years rather than immediate vesting.

The recently issued proposed IRS regulations on the PPA safe harbor provisions are effective for plan years beginning on or after January 1, 2008. The IRS has indicated that taxpayers may rely on these proposed regulations pending the issuance of final regulations. If the final regulations turn out to be more restrictive than the proposed regulations, those provisions of the final regulations would be applied without retroactive effect.

There is a cost to adopting either of the 401(k) design based safe harbors. However, for those clients that consistently have nondiscrimination testing problems, such clients may wish to consider the safe harbors. If we can assist you in any way with that analysis, please let us know.

Manes M. Merrit	212-451-2330
Nina Krauthamer	212-451-2242
Barry L. Salkin	212-451-2212
Annette Messano	212-451-2370