

October 22, 2003

**By Hand-Delivery**

Internal Revenue Service  
CC:ITA:RU (REG-108639-99)  
Room 5226  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20044

Re: Proposed Regulations Related to Cash or Deferred Arrangements under Section 401(k) and Matching Contributions or Employee Contributions under Section 401(m)

Dear Sir or Madam:

This comment letter is submitted by the American Benefits Council (the “Council”) with respect to Proposed Regulations sections 1.401(k)-0 through 1.401(k)-6 and 1.401(m)-0 through 1.401(m)-5 (the “Proposed Regulations”).

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council’s members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans. The Proposed Regulations would have a significant impact on the 401(k) and 401(m) plans sponsored and serviced by our members. We submit these comments, which represent the highest priority issues identified to date by our members, in order to initiate a productive dialogue with the Internal Revenue Service and Department of the Treasury.

The Council believes that these Proposed Regulations represent an important step forward in both simplifying the regulatory requirements applicable to Code section 401(k) and 401(m) plans and consolidating previously issued guidance. The layout and format make these Proposed Regulations easy to navigate and understand. Nevertheless, we have identified several items in the Proposed Regulations where additional clarification would be helpful. The Council’s comments are set forth below.

## **ESOP TESTING**

The Council strongly supports the change in testing for Employee Stock Ownership Plans (“ESOPs”) under the Proposed Regulations and suggests that this change be expanded. Under the Proposed Regulations, the portion of a cash or deferred arrangement that is an ESOP and the portion of a plan that is not an ESOP would no longer be required to apply the mandatory disaggregation rule of Treasury Regulations section 1.410(b)-7(c)(2) when conducting the plan’s Average Deferral Percentage (“ADP”) and Average Contribution Percentage (“ACP”) tests. The Council strongly believes that this change represents a positive step in reducing the complexity of the nondiscrimination requirements applicable to cash or deferred arrangements. Nevertheless, the mandatory disaggregation rule will continue to apply for other testing purposes, including testing of benefits, rights and features (“BRF”). For example, if a plan provides for different rates of matching contributions based on length of service, the right to receive each rate of match must be tested under the BRF rules. Under current law, the availability of each matching rate under the ESOP feature of a 401(k) plan must be tested separately from the availability of each rate under the non-ESOP portion of the plan. In a 401(k) plan under which the employer stock investment option is an ESOP, and all participants are eligible to invest in employer stock, mandatory disaggregation is not necessary to prevent avoidance of the minimum coverage rules. Thus, in order to further simplify testing of 401(k) plans that include an ESOP feature, the Council urges the Treasury Department (“Treasury”) and the Internal Revenue Service (the “Service”) to extend the new rule under the Proposed Regulations to apply to testing under Code sections 401(a)(4) and 410(b).

In addition, the Council urges that plan sponsors be permitted to apply this portion of the regulations to plan years beginning in 2003 and later years. The proposed rules obviously and appropriately recognize that the current rule requiring separate testing needlessly complicates the administration of ESOPs that are part of 401(k) plans. There is no need to wait until the first plan year after the final regulations are issued to alleviate this complexity.

## **CHANGES IN TESTING METHODS**

Further clarification is needed on the extent to which testing methods may be changed during or after a plan year. The Proposed Regulations incorporate previously issued guidance on prior year and current year testing with some modifications. Notice 98-1 permitted a plan to be amended to change from the prior year testing method to the current year testing method for “any subsequent plan year.” The Proposed Regulations now state that a plan is permitted to change from prior year to current year testing for “any plan year.” The elimination of the term “subsequent” from the language in Notice 98-1 appears to confirm that a plan could be amended during the plan year or after the end of the plan year to change from prior year to current year testing. Nevertheless, there have been some suggestions that a plan cannot be amended to change testing methods after the end of the plan year except in the circumstances described in Proposed Regulations section 1.401(k)-2(c)(1)(ii)(C), which permits a plan involved in a corporate transaction to change from current year testing to prior year testing during the Code section 410(b)(6)(C) transition period if, as a result of the transaction, the employer maintains both a plan using the current year testing method and a plan using a prior year testing method.

Generally, the rules for changing from current year to prior year testing are more restrictive than the rules for changing from prior year to current year testing.

The meaning of the Proposed Regulations should be clarified to provide that plans are permitted to change from prior year to current year testing during the plan year and after the end of the plan year, particularly in circumstances involving a corporate transaction. From a business standpoint, a corporation's decision whether or not to enter into a corporate transaction is not, and should not, be influenced by the transaction's potential impact on a plan's ADP and ACP test results. For this reason, corporations need flexibility in applying ADP and ACP tests after a period of corporate growth or divestiture. Thus, the rules for changing from prior year to current year testing should permit plans that are involved in corporate transactions to change testing methods within the Code section 410(b)(6)(C) transition period after a corporate transaction without regard to whether the employer will maintain a plan using the current year testing method and a plan using a prior year testing method after the transaction.

### **CALCULATION AND ALLOCATION OF GAP PERIOD INCOME**

The Proposed Regulations specifically ask for comments on areas where the Proposed Regulations unduly complicate plan administration. One such complication is caused by the reinstated requirement of allocating gap period income to excess contributions in daily valued plans. Under existing regulations, daily valued plans have the option of excluding gap period earnings, and the "gap period" is defined as the period between the end of the plan year and the date of the distribution [Treas. Reg. Section 1.401(k)-1(f)(4)(ii)]. Proposed Regulations section 1.401(k)-2(b)(2)(iv) is not as clear as the current regulatory definition, stating that the "gap period" is the period after the close of the plan year. In addition, it appears the choice of excluding gap period earnings has been eliminated.

Many administrative and recordkeeping systems are currently designed to pick up the contribution data and earnings numbers as of the plan year end. The recordkeeper often forwards to the plan administrator or plan sponsor information on the excess contributions and excess aggregate contributions along with the allocated gain or loss. Under the current system, this allows for more accurate and timely communication that enables affected participants to prepare their tax returns without having to wait for their corrective distribution. The proposed change to include gap income would require substantial modifications to recordkeeping systems and would impose administrative delays on participant communications. The Council believes these issues would be eliminated by reinstating the option to exclude gap period income.

In addition, the alternative method for allocating gap period earnings in the Proposed Regulation does not work for most daily valued plans. Normally, in the daily valued environment, distributions are valued at the closing price of the investments on the day the funds are redeemed. Administrative systems for daily valued plans generally cannot calculate the earnings and process a redemption on the same day because earnings for that day cannot be determined until after the stock market closes. At that point, assets in the plan cannot be sold to make the distribution until the next business day. As a result, the Proposed Regulations lock the daily valued plan into the safe harbor method (calculating gap income as 10% of the plan year income for each month in the gap period), which may not be equitable if the plan's investments

performed well during the plan year but incurred a significant loss during the gap period. The Council strongly urges Treasury and the Service to continue to allow plans to exclude gap period earnings. If gap period earnings are required to be included in a corrective distribution, a time delay should be built in for daily valued plans. For example, the gap period could end on the last valuation date of the month preceding the distribution, or any valuation date within a certain number of days of the distribution.

### **CALCULATION OF GAP PERIOD EARNINGS – ALTERNATIVE FORMULA**

The Council also urges Treasury and the Service to clarify the calculation under Proposed Regulations section 1.401(k)-2(b)(2)(iv)(E). That section provides the following alternative method for calculating plan year and gap period earnings:

*(E) Alternative method for allocating plan year and gap period income.* A plan may determine the allocable gain or loss for the aggregate of the plan year and the gap period by applying the alternative method provided by paragraph (b)(2)(iv)(C) of this section to this aggregate period. This is accomplished by substituting the income for the plan year and the gap period for the income for the plan year and by substituting the contributions taken into account under this section for the plan year and the gap period for the contributions taken [into] account under this section for the plan year in determining the fraction that is multiplied by that income. [Emphasis added.]

From this language, some Council members indicated they would use the following calculation for income:

$$\frac{[\text{income for the plan year}] + [\text{income for the gap period}]}{[\text{beginning account balance plus contributions made during the plan year and the gap period}]} \times [\text{excess contributions for the plan year}]$$

However in example 3 in Proposed Regulations section 1.401(k)-2(b)(2)(viii), the calculation is broken into a two-step process. First, the income on the excess contribution for the plan year is calculated. Second, the income on the total of the excess plus income for the plan year is calculated for the gap period. This two-step method will produce a slightly different result from the calculation above and is likely to require changes to many systems currently in place by recordkeepers. The Council urges Treasury and the Service to clarify the method used to calculate the earnings, for the plan year and the gap period, under the alternative method. The Council prefers the original one step method outlined in the Proposed Regulations, not the two-step method described in the example.

### **PARTICIPATION BY OTHERWISE EXCLUDABLE EMPLOYEES**

Proposed Regulations section 1.401(k)-1(b)(4)(iv)(A) discusses disaggregation of plans and separate testing where a plan permits participation by otherwise excludable employees (those who have not completed the minimum age and service requirements of Code Section 410(a)(1)(A)). The Proposed Regulations do not address an outstanding issue regarding which

employees are excludable. Plans can exclude employees who have not attained age 21 or completed one year of service, and plans are permitted to have entry dates only once every six months (generally January 1 and July 1 for a calendar-year plan). For example, if a plan allows participation as of the first of every month, the question is whether the excludable group is those employees who (1) have not attained age 21 and completed one year of service as of the last calendar month in the plan year, or (2) have not completed 18 months of service and attained age 21-1/2 by the last day of the plan year (because they would not have been eligible to enter under a typical twice-a-year entry plan until the first day of the following plan year). The Council supports the second interpretation as the logical interpretation because these are the employees that could have been excluded from the plan.

The Proposed Regulations also indicate that if a plan sponsor has two plans, one plan for otherwise excludable employees, and another plan for those who have met the minimum age and service requirement, then the plan sponsor need not provide the safe harbor matching contribution to participants in the otherwise excludable plan in order for the larger plan to meet the safe harbor requirements. However, if the plan sponsor has only one plan, then the otherwise excludable employees must receive the safe harbor match. The Council believes it is logical to allow plan sponsors to have one plan to achieve what they currently can do with two. In both cases, the result would be the same – excludable employees would be able to participate but not receive the matching contribution.

### **USERRA MAKE-UP CONTRIBUTIONS**

The Proposed Regulations do not address the treatment of prior year contributions made on account of the Uniformed Services Employment and Reemployment Rights Act (USERRA). Persons returning to employment after a USERRA break for active duty in the military are permitted to make contributions to the plan for the period for which he/she served. Those contributions are not supposed to count in the ADP/ACP tests. The Council suggests that this issue be addressed in the Proposed Regulations.

### **CORRECTIVE DISTRIBUTIONS**

The Council believes that the Treasury and the Service should take a fresh look at the timing of taxation of corrective distributions for non-calendar year plans. Proposed Regulations section 1.401(k)-2(b)(2)(vi)(A) provides that excess contributions distributed within 2 ½ months after the end of the plan year must be included in the income of the employee on the earliest date any elective contributions would have been received by the employee had he or she elected to receive the amounts in cash. This rule is unworkable in the context of a non-calendar year plan. For example, where the plan year begins on December 1, 2003 and ends on November 30, 2004 plan year, and the plan sponsor makes a corrective distribution on February 5, 2005, the corrective distribution is treated as taxable income in the employee's 2003 tax year. This requires the employee to file an amended 2003 tax return, possibly paying interest and penalties for underpayments of the 2003 income tax. This rule imposes an undue burden on employees who might have no control over the business affairs of the company. A rule that would permit the distribution to be taken into account in the later year would simplify plan administration and minimize the burdens on employees who receive corrective distributions.

If the guidance is not modified in this manner, the Council seeks clarification that the timing of the taxation of the corrective distribution for a non-calendar year plan has not changed under the Proposed Regulations. The Proposed Regulations state that excess contributions (and income) distributed within 2½ months after the end of the plan year are includable in the employee's gross income on the earliest **date any** elective contributions by the employee would have been received in cash. The existing regulations say "...earliest **dates any...**" A literal interpretation of the new provision could lead to contrary results.

For example, assume a plan has a fiscal year of December 1, 2005 through November 30, 2006. Participant A, a highly compensated employee defers \$1,000 per month from his pay. The ADP test for the 2005-2006 plan year is failed and a corrective distribution completed within 2½ months following the end of the plan year. As a result of the failure, A receives a corrective distribution of \$3,000 in excess contributions, plus earnings. Under existing regulations, A would have taxable income of \$1,000 plus earnings for the calendar year 2005 and taxable income of \$2,000 plus earnings for the calendar year 2006. The earliest dates the deferrals would have been received in cash. Under the proposed regulations it appears the full \$3,000 plus earnings could be considered taxable income in calendar year 2005, the earliest date any elective contribution would have been received in cash.

The preamble does not contain a reference to this change so it would be helpful for Treasury and the Service to clarify whether this is the intended result. The Council strongly urges retention of the current rule (absent modification of the rule for non-calendar year plans as described above). To do otherwise would, in some situations, subject the highly compensated employee to tax in an earlier year than he or she would have been taxed if the compensation had been received instead of contributed to the plan.

The Council also requests clarification of one of the examples of corrective distributions. In Proposed Regulations section 1.401(k)-2(b)(2)(viii), Example 4, the \$100,000 in employee A's plan account "attributable" to elective contributions at the beginning of the 2006 plan year could represent \$100,000 of elective contributions actually made in prior years or the sum of those prior years' elective contributions with associated earnings. The Council believes the appropriate interpretation is that the \$100,000 includes associated investment earnings.

With respect to distributions of excess aggregate contributions, Proposed Regulation section 401(m)-2(b)(2)(vi)(A) provides that "the portion of the distribution that is treated as an investment in the contract under Section 72 is determined without regard to any plan contributions other than those distributed as excess aggregate contributions." This sentence is susceptible of more than one interpretation. For example, the portion of the distribution to be treated as an investment in the contract and, thus not subject to tax, could be equal to (i) the amount of the excess aggregate contributions being distributed, or (ii) the total amount being distributed multiplied by the ratio of (i) the excess aggregate contributions being distributed to (ii) the total balance in the account. The Council believes that this portion of the Proposed Regulations should be clarified.

## **ELECTIVE CONTRIBUTIONS TAKEN INTO ACCOUNT UNDER THE ACP TEST**

The proposed regulations include an example of “shifting” money from the ADP test to help the plan pass the ACP test [Proposed Regulations section 1.401(m)-2(a)(7) example 3]. In the example, only one employee’s elective contributions are moved from ADP to ACP test. Under the existing regulations, shifting was based on the ADP or ACP of the specific group, not shifting one, or more, individual’s ratios. The Council requests clarification of whether the intent of the Proposed Regulations is to allow contribution “shifting” to the ACP test on an individual participant basis? Using the data in the Proposed Regulations’ example, a similar result could have been achieved by shifting based on the ADP as a whole rather than one individual.

## **PREFUNDING**

The Council believes that clarification is needed with respect to Proposed Regulations sections 1.401(k)-1(a)(3)(B) and 1.401(m)-1(a)(2)(iii), which provide that contributions made in anticipation of an employee’s deferral election or future performance of services may not be treated as elective or matching contributions. Under this rule, a contribution is not a matching contribution if it is contributed before the employee contribution and a pre-tax deferral is only treated as such if it is contributed after the deferral election is actually made. As drafted, the proposed rule is overbroad. In the case of matching contributions, it would reach matching contributions made early in a year for allocation during the year, regular forfeitures under a plan, and forfeitures that are taken in a later year and reallocated as matching contributions on account of errors that occurred in a prior year. Further, in a leveraged ESOP it is common for the employer’s debt payments to be made annually or bi-annually, which then result in a release from the ESOP suspense account and allocations during the year to participants’ accounts. The proposed rule would prevent such contributions from being treated as matching contributions. Thus, the Council suggests that the Proposed Regulations be revised to provide that the rule will not apply to: (1) matching contributions made during the year where the plan that provides that all amounts contributed during a year must be allocated no later than the end of that year; (2) regular forfeitures that are used in a later year (after the underlying contribution was made) as a matching contribution in a later year; (3) reallocations of previously contributed matching contributions made in a later year to correct errors made in an earlier year; and (4) contributions made during the year to a leveraged ESOP to release shares to be allocated for the current plan year or as of a date in a prior plan year provided the reallocation is within the time period set forth in the existing rules governing contributions made after the end of a plan year. In the case of pre-tax elective deferrals, similar exceptions to the general rule should apply to address the reallocation of previously contributed amounts that are reallocated due to errors in plan administration or other amounts contributed during a year as part of an employer’s pre-tax contribution to the plan as long as all amounts are allocated to participants’ accounts no later than as of the end of the plan year in which the amounts are contributed.

## **LEASED EMPLOYEES**

The Proposed Regulations request comments on whether a change in status from employee to leased employee under Code section 414(n) should be treated as a severance from

employment that would permit a distribution to be made. The Council believes that when Code section 401(k)(2)(B)(i)(I) was changed from “separation from service” to “severance from employment,” Congress intended to simplify the distribution requirements and avoid the quagmire of the “same desk rule” that had been developed to distinguish between various situations in which employees changed their job status. The Council is concerned that these complicated rules will be resurrected if the Treasury now attempts to draw lines to distinguish cases where participants move from a common-law employment status to a leased employee position, which by definition requires that the participant be the common-law employee of a third-party. The legal issues relating to a change in status from employee to leased employee have far-reaching implications, and the Council believes that the 401(k) and 401(m) regulations are not the proper place to address this issue at this time.

### **HARDSHIP DISTRIBUTIONS**

The Council expresses its support for the efforts to clarify the rules under which an employer may rely on a participant’s certification for purposes of making a hardship distribution. In particular, the Council urges the government to retain the portions of the Proposed Regulations that provide that a commercial loan need not be taken if the loan would not be enough to satisfy the need and that participants need not take counterproductive actions. Although the Proposed Regulations retain the reasonableness standard from the current regulations, the preamble to the Proposed Regulations contains language that indicates that a participant must liquidate his or her assets and exhaust all plan loans before taking a hardship distribution even if each asset or loan would not satisfy the need. The Council believes that the Proposed Regulations should be revised to clarify that the phrase “reasonably be relieved” does not require a participant (1) to liquidate assets that are not valuable enough to satisfy the financial need or (2) to take a plan loan if she or she cannot take on the accompanying monthly payment obligation.

### **TARGETED QNECS AND QMACS**

The Proposed Regulations limit a plan’s ability to use bottom-up leveling to correct ADP and ACP test failures by providing new formulas for determining whether QNECs and QMACs may be counted towards the relevant tests. The new rules for targeted QNECs and QMACs are overly complex and will impose severe burdens on plan sponsors and administrators. Implementation of the proposed formulas will require substantial changes to computer systems and administrative practices that will result in a considerable increase in administrative costs. Some plans have language spelling out the use of bottom-up QNECs as the correction method for ADP/ACP failures and these plans have received Determination Letters. Furthermore, in industries in which employers experience a high turnover rate among non-highly compensated employees, bottom-up leveling has been a viable method of correcting ADP and ACP failures. For this reason, the Council urges the Treasury Department and the Service to reconsider its position on targeted QNECs and QMACs and adopt simplified rules, such as a flat dollar amount safe harbor, that will relieve the financial burden on plan sponsors.

## ANNUAL NOTICE OF DEFERRAL RIGHTS

Proposed Regulations section 1.401(k)-1(a)(3)(ii) permits the use of automatic enrollment of individuals as soon as they become eligible without their having to make any election. However, there is no reference to the requirement of a prior notice or annual notice as outlined in Revenue Rulings 98-30 and 2000-8. Section 1.401(k)-1(e)(2)(ii) of the Proposed Regulations on frequency of elections states that all participants must have an opportunity to make or change a cash or deferred election at least once during each plan year. Additionally, the regulations state that one relevant factor will be notice of the availability of the election. Does this provision require plans to formally provide all participants with an annual notice of their rights to make or change a cash or deferred election? If so, the Council urges Treasury and the Service to more specifically outline the content, timing and distribution requirements of the notice.

## MERGERS & ACQUISITIONS

The Proposed Regulations reserve on the issue of testing plans sponsored by companies that have been involved in corporate transactions. In Notice 2000-3, the Service requested comments on the application of nondiscrimination requirements in mergers, acquisitions, and other corporate transactions. As we stated in our comment letter of March 28, 2000, we continue to urge Treasury and the Service to issue guidance that would provide plan sponsors with flexibility in performing ADP and ACP testing after a corporate transaction. For this reason, any regulations issued in the future should permit companies involved in corporate transactions to continue testing on a pre-transaction basis, or, in the case of mid-year transactions, on a short plan year basis. Furthermore, because the precise data needed to perform ADP and ACP tests under current guidance is not always available to an acquiring company at the time of an acquisition, plan sponsors should be afforded some flexibility in the quality of data that can be used in performing required tests.

\* \* \*

Again, we appreciate the opportunity to comment on these Proposed Regulations and we look forward to continued discussion of the important issues addressed. If additional information from us would be helpful, please do not hesitate to contact me or Jan Jacobson, the Council's Director, Retirement Policy.

Sincerely,

James A. Klein  
President

cc: Michael T. Doran (Deputy Benefits Tax Counsel, Department of the Treasury)

Carol D. Gold (Director, Employee Plans, TEGE, Internal Revenue Service)  
Sarah Hall Ingram (Division Counsel/Associate Chief Counsel, TEGE, Internal Revenue Service)  
Nancy J. Marks (Deputy Division Counsel/Deputy Associate Chief Counsel, TEGE, Internal Revenue Service)  
Paul T. Shultz, III (Director, Employee Plans Rulings & Agreements, TEGE, Internal Revenue Service)  
William F. Sweetnam, Jr. (Benefits Tax Counsel, Department of the Treasury)  
Alan N. Tawshunsky (Assistant Chief Counsel, TEGE, Internal Revenue Service)