Final Section 401(k) and (m) Regulations Contain Substantive Changes

Elective deferrals, aggregation rules, and hardship distributions are among the areas that have been revised or clarified by the new rules.

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Final Regulations under Sections 401(k) and (m) (TD 8357, 8/8/91) make significant changes to the package of Proposed and final Regulations published in 1988.[1] Of particular note are new rules on restructuring, separate testing requirements for collectively bargained employees and ESOPs, hardship distributions, and distributions following plan terminations and corporate mergers or acquisitions.

Nondiscrimination Testing

The ADP and ACP tests—no restructuring after 1991. Since the Section 401(a)(4) Proposed Regulations were issued in May 1990,[2] many employers have taken advantage of "restructuring" in determining whether the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests are satisfied.[3] Through the 1991 plan year, restructuring can help a plan pass the tests if the plan covers more nonhighly compensated employees (non-HCEs) than are needed to pass the ratio coverage (70%) test under Section 410. The plan is restructured into employee groups to combine contributing HCEs with contributing non-HCEs. The ADP and ACP tests are then applied separately to the restructured employee groups, resulting in a higher contribution limit for HCEs than would be possible if the HCEs were grouped with non-HCEs who failed to contribute or who contributed at a very low level.

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The Preamble to the September 1990 amendments to the Section 401(a)(4) Proposed Regulations (EE-49-90, 9/12/90) acknowledged that restructuring was available to 401(k) and (m) plans, but put employers on notice that IRS might limit that availability. Final Regs. 1.401(k)-1(b)(3)(iii) and 1.401(m)-1(b)(3)(iii) impose the most restrictive limitation considered in the September 1990 proposal and prohibit 401(k) and (m) plans from using restructuring for plan years beginning after 1991. Although the restructuring rules can be used for pre-1992 plan years, the final Regulations do not go much beyond previous guidance, merely adding that other employee groupings must not be a subterfuge for grouping by deferral percentages and must satisfy the "reasonableness" test under the Section 410(b) average benefits test.[4] Thus, restructuring criteria for pre-1992 plan years remain quite vague and leave ample room for imaginative application of the rule.

For post-1991 plan years, employers can still obtain the results of restructuring by setting up separate plans in advance of the year, combining plans as needed to satisfy the ADP and ACP tests. This is acceptable to the Service, apparently because an employer must divide employees into describable groups. Since IRS was unable to define an acceptable employee group for restructuring purposes, the Regulations force employers to go through the formalities of separate plans. Employers may find that in return for minimum administrative inconvenience they can dramatically improve their test results by setting up separate plans.

Collectively bargained employees. The final Regulations clarify two points involving the testing of collectively bargained employees.

1. A plan covering only collectively bargained employees *must* be tested under Section 401(k), even though collectively bargained plans are *per se* nondiscriminatory under Section 401(a)(4). The ADP test is not just a substitute for the Section 401(a)(4) nondiscrimination test, but rather is a precondition to the constructive receipt relief afforded by Section 401(k) (Reg. 1.401(k)-1(a)(7)). Matching contributions and employee after-tax contributions under a collectively bargained plan, however, do not have to pass the Section 401(m) test because that is solely a nondiscrimination test and there are no constructive receipt ramifications (Reg. 1.401(m)-1(a)(3)). Apparently because of the confusion about the proper treatment of collectively bargained Section 401(k) plans, the effective date of the Section 401(k) testing requirement is delayed until plan years beginning in 1993.

2. With regard to the disaggregation rule of Section 410(b) as applied to the ADP and ACP tests, if a Sec-

tion 401(k) or (m) plan covers both union and nonunion employees, the employer must perform multiple ADP and ACP tests—an ADP test for *each* collective bargaining unit and an ADP and ACP test for the noncollectively bargained employees (Regs. 1.401(k)-1(b)(3)(ii)(B) and 1.401(m)-1(b)(3)(ii)). This disaggregation rule applies retroactively to 1/1/89, although the final Regulations provide that a "reasonable interpretation" of the Section 401(k) and (m) rules suffices for years beginning before 1992. It is surprising that the Regulations do not provide more explicit retroactive relief in this situation. Many employers performed a single ADP or ACP test for pre-1992 years and might fail the tests for the noncollectively bargained group if disaggregated. Whether it was reasonable to combine the testing of bargained and nonbargained groups is not an easy question, given the clear disaggregation rule spelled out in the Section 410(b) Proposed Regulations. The "reasonable interpretation" approach does not apply to the 1992 plan year, however, so the tests will have to be performed separately for 1992. As noted above, collectively bargained plans are given relief under the ADP test until 1993 so that an ADP test need be performed only for the noncollectively bargained employees in 1992.

Other separate testing requirements. The Regulations also clarify that separate testing is required for (1) the ESOP and non-ESOP portions of a Section 401(k) or (m) plan, (2) each employer in a "multiple employer plan" and (3) each separate line of business in a plan covering more than one such line of business. The effective dates for these disaggregation rules are different from those for collectively bargained plans. Under Reg. 1.401(k)-1(g)(11)(iii)(B), the ESOP separate testing rule applies to plan years that begin after 1989. The other separate testing rules apply back to the 1989 plan year, according to Reg. 1.410(b)-10(a).

Oddly, the Regulations fail to address the separate testing requirement that applies if the employer takes advantage of the rule under Section 410(b) allowing separate testing of participants who could have been excluded under the age and service rules. The required disaggregation of these employees is covered in Reg. 1.410(b)-7(c)(3). The Section 401(k) Regulations refer broadly to the Section 410(b) disaggregation rules, so it appears that disaggregation would be required for the otherwise excludable employees even though the Section 401(k) Regulations do not specifically mention it.

Compensation period for testing purposes. As expected, the Regulations clarify that the compensation taken into account under the Section 401(k) and (m) tests may be limited to that received while an employee is eligible to participate. *Rev. Proc.* 89-65, 1989-2 CB 786, provided that plans could use such a limited definition of compensation until the final Section 401(k) and (m) Regulations were issued, and the Section 401(a)(4) Regulations also allow this approach. Regs. 1.401(k)-1(g)(2)(i) and 1.401(m)-1(f)(2) allow plans to calculate compensation based on the calendar year ending within the plan year.

Determining the eligible group. Under Reg. 1.401(m)-1(f)(4)(i), the group of eligible employees who are counted for the 401(m) tests does not include any employee who must perform additional service in order to be eligible to receive matching contributions for a plan year. Many plans require an employee to be employed on the last day of the plan year to be entitled to an allocation of a matching contribution; the ability to ignore employees who quit mid-year makes the ACP test easier to satisfy.

Counting nonelective contributions. As did the Proposed Regulations, the final Regulations allow qualified nonelective contributions (QNECs) to be counted toward the Section 401(k) and (m) tests.[5] The Proposed Regulations, however, did not allow QNECs to be counted under those tests if the effect was to increase the difference between the ADP for HCEs and non-HCEs.[6] The rationale for this restriction eluded most observers, and it has been deleted in the final Regulations.

Multiple use limitation. With one exception, the final Regulations make few changes in the rules regarding multiple use of the "2+2" test under the ADP and ACP tests.[7] The change deals with the ability to treat Section 401(k) deferrals as matching contributions under the Section 401(m) test in order to avoid a cutback under the multiple use test.

EXAMPLE: A Section 401(k) plan with a dollar-for-dollar employer match reflects the following:

	ADP	ACP
HCEs	7%	7%
Non-HCEs	5%	5%

It appears that the multiple use test is violated, because neither the ADP nor the ACP test passes using the 1.25-to-1 test. But if three percentage points for the Section 401(k) test could be counted under the Section 401(m) test, the results would be as follows:

	ADP	ACP
HCEs	4%	10%
Non-HCEs	2%	8%

As recast, the plan would not violate the multiple use test because the Section 401(m) test now passes under the 1.25-to-1 test. It was uncertain whether this technique worked because Prop. Reg. 1.401(m)-2(b)(1) limited the ability to count the elective deferrals under the Section 401(m) test to "the amount necessary to meet the requirements of [the 2+2 test]." This wording left unclear whether the elective deferrals could be moved to the Section 401(m) test when that test already was passed without considering the Section 401(k) amounts. Since final Reg. 1.401(m)-2(b)(1) does not contain the proviso, any employer that cut back contributions because of the dual use test should ensure that the rules are being used to their full advantage.

Clarification is required as to the proper method of cutting back contributions when the dual use test is not met. The final Regulations provide that the ACP *or* the ADP may be cut back to pass the test, suggesting that an employer may not cut back both. A Government official has stated, however, that the intention was to permit a

cutback under both the ADP *and* ACP tests. Many employers cut back both sides of the plan in this situation and presumably will continue this practice.

KSOPs and MSOPs. The final Regulations address a couple of key issues affecting the testing of Section 401(k) or (m) plans that contain ESOPs (KSOPs or MSOPs), but leave other important issues open. For instance, the Preamble notes that the Service has not decided whether Section 404(k) dividends should be tested as contributions under Sections 401(k) and (m). This and other issues dealing with leveraged KSOPs and MSOPs will be covered by a separate Regulations project.

The final Regulations provide that the KSOP or MSOP is tested for discrimination under the ADP or ACP test, but, as noted above, the KSOP or MSOP portion is tested separately from the rest of the plan. Accordingly, it appears that the IRS has abandoned the idea of imposing a stricter Sections 401(k) and (m) nondiscrimination test for ESOPs.[8]

If an HCE participates in both the ESOP and non-ESOP parts of a Section 401(k) plan, the Regulations also clarify that separate ADP ratios are calculated for the HCE for each part of the plan. There had been some uncertainty on this because the law generally calls for composite ADP and ACP calculations when an HCE participates in more than one such arrangement of the employer.

Much-needed guidance is provided on application of the multiple use test for KSOPs and MSOPs. Reg. 1.401(m)-2(b)(1) (flush language) clarifies that the multiple use test, like the ADP and ACP tests, is applied separately to the ESOP and non-ESOP portions of the plans.

EXAMPLE: An employer had a Section 401(k) plan with a dollar-for-dollar match and the matching contributions were deemed an ESOP. The testing percentages were as follows:

	401(k)/ADP	ESOP/ACP
HCEs	7%	7%
Non-HCEs	5%	5%

Under the Proposed Regulations, it was unclear whether the multiple use test would have been violated because the 2+2 test is used in both the ACP and ADP tests. Because the multiple use test applies separately to both parts of the plan, however, no adjustment is called for under the final Regulations.

Government plans. Government plans are not required to meet the ADP and ACP tests for plan years beginning before 1993. This is similar to the transition rule in the Section 401(a)(4) Regulations. The Section 401(k) transition relief applies only to those Governmental units with pre-5/7/86 Section 401(k) plans and that still qualify to maintain a cash or deferred plan.

Correcting Excess ADP and ACP

Determining the excess amount. Many employers had complained about the method in the Proposed Regulations for correcting a Section 401(k) or (m) excess. The ADP or ACP of the HCE with the highest ADP or ACP must be reduced to the level of the HCE with the next highest ADP or ACP, and so on. This "leveling" approach is unpopular because it tends to target the lowest-paid HCEs and because it often results in a very small repayment or recharacterization to a large number of HCEs. Unfortunately, the leveling method continues to be the exclusive means under the final Regulations for determining the excess. According to the Preamble, the Service believes that the statute compels use of a leveling rule once the plan year has closed. Alternatively, under Regs. 1.401(k)-1(f)(1)(ii) and 1.401(m)-1(e)(1)(i), a plan may limit deferrals by HCEs during the plan year.

Correcting a test failure. If an employer fails the Section 401(k) tests, it may recharacterize or distribute the excess or make additional contributions (QNECs) for the non-HCEs. Reg. 1.401(k)-1(b)(5) clarifies that QNECs may be made with respect to any or all employees under the plan, so that the employer can specifically target the QNECs to the extent otherwise consistent with the definite allocation formula requirement.

An employer who fails the Section 401(m) test may make additional contributions for non-HCEs, distribute any after-tax contributions or vested matching contributions to participants, or forfeit any nonvested matching contributions. As with Section 401(k), nonelective employer make-up contributions can be made with respect to any or all employees under the plan (Reg. 1.401(m)-1(b)(5)). Reg. 1.401(m)-1(e)(6), Example 7, clarifies that an employer may not distribute otherwise nonvested matching contributions because the distribution would be a discriminatory acceleration of vesting for the affected HCEs.

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1 See Hamburger, "New Final and Proposed Regs. for 401(k) Plans: Parts I and II," 69 JTAX 284 and 378 (November and December 1988). Aspects of the 1988 Regulations that were not controversial and are unchanged in the final Regulations will not be discussed here.

2 See generally Quintiere, "'Exclusive' Nondiscrimination Rules May Steer Qualified Plans Toward Safe Harbors," 73 JTAX 68 (August 1990).

3 Evelyn Petschek, Treasury Deputy Benefits Tax Counsel, announced that a "follow-on" Regulation to the final Sections 401(k) and (m) Regulations soon will be issued. The Regulation will cross-reference the final nondiscrimination rules under Section 401(a)(4) (TDs 8359-8363, 9/12/91), and will clarify some of the issues under the final Section 401(k) Regulations.

4 Reg. 1.401(k)-1(h)(3)(iii). To pass the "reasonableness" standard, a classification must be established under "objective business criteria." According to Reg. 1.410(b)-4(b), "[r]easonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification."

5 Under Reg. 1.401(k)-1(g)(13), QNECs must satisfy the Section 401(k) vesting and withdrawal restrictions to be counted under the Section 401(k) test.

6 Prop. Regs. 1.401(k)-1(b)(3)(vii); 1.401(m)-1(b)(2)(vii).

7 The dual use (or multiple use) test is failed if an HCE has contributions that are tested under Sections 401(k) and (m) and both the ADP and the ACP tests are passed by looking only to the 2+2 test; if either the ADP or the ACP test passes the 1.25-to-1 test, there is no multiple use problem. See Sections 401(k)(3)(a)(ii) and 401(m)(2)(A).

8 For instance, there had been suggestions that the Service might require a 1-to-1 actual deferral test for an ESOP under Section 401(k) or (m), rather than the 1.25-to-1 and 2+2 tests.

9 Regs. 1.401(k)-1(f)(4)(ii)(B), 1.401(m)-1(e)(3)(ii)(B), and 1.402(g)-1(e)(5)(ii).

Determining income on the excess. The final Regulations add welcome flexibility when determining the income that must be distributed or recharacterized when the Section 401(k) or (m) test is not met. There is a safe harbor, but a plan also may use any reasonable method for allocating income to the excess. The safe harbor approach itself has been liberalized. The Proposed Regulations had included a detailed definition of allocable "income" that included unrealized as well as realized gains. The final Regulations drop all of this detail, and allow the employer to decide the scope of the income definition.[9] Whichever method of allocation is used—the safe harbor or the employer-designed approach—the Regulations also make it optional for the employer to allocate post-year-end income ("gap period" income) to the excess (as long as the plan document so provides).[10]

Contribution Limits

Section 401(k) dollar limit. A Section 401(k) plan must expressly limit elective deferrals to $7,000 (adjusted for inflation, this is $8,475 for 1991), combining for this purpose all Section 401(k) plans of the employer and any aggregated entity (Reg. 1.401(a)-30).[11] A plan faces disqualification if contributions to one or more plans of the same or aggregated employers exceed the limit. To prevent disqualification, a plan may, under Reg. 1.402(g)-1(e)(2), provide for the automatic repayment of excess deferrals occurring under the employer's or the related entity's plan. This clarification was needed because the general rule makes it the employee's obligation to notify the employer of an excess deferral, and does not permit a corrective distribution unless such notification is given. Of course, the general rule contemplates that the excess deferral may have been due to contributions to an unrelated employer's plan, which would not jeopardize qualification of either plan.

Section 415 limit. Reg. 1.415-6(b)(6) is amended to permit the repayment of salary reduction contributions to a participant if there is a reasonable error in determining the elective deferrals that may be made. Previously, the Section 415 Regulations allowed the repayment of *employee* after-tax contributions if there was a mistake in determining the Section 415 limits, but *employer* contributions causing a Section 415 excess had to be left in the plan and reallocated to other participants or held in a suspense account. The wording of the amended Regulation suggests that it may be easier to return a salary reduction contribution than an after-tax employee contribution, *i.e.*, the former may be returned to a participant if there is any reasonable error in determining the Section 415 limit, whereas after-tax contributions may be returned only if there is a reasonable error in estimating a participant's compensation. No explanation is given for this apparent difference.

401(k) and (m) plans may not use restructuring for plan years beginning after 1991.

Also, the amendment deleted a provision under which the plan had to distribute earnings on after-tax employee contributions or the earnings would be "annual additions." It now appears that earnings on before- and after-tax elective contributions may remain in the plan without Section 415 consequences. There have been informal indications, however, that this change in the treatment of earnings was unintended.

Reg. 1.415-6(b)(6)(iv) clarifies coordination of the Section 415 limit with the Section 401(k) test. Elective contributions, both before- and after-tax, that are distributed because of Section 415 are not counted under the Section 401(k) or (m) test.

Hardship Distributions and Participant Loans

The final Regulations liberalize the hardship rules in several ways, some of them significant.

No restrictions on amending hardship provisions. New procedures for handling hardship requests were outlined in the 1988 Regulations. Although the date for amending plans was extended through the deadline for TRA '86 amendments, employers were forced to implement hardship provisions that complied with the 1988 Regulations by 3/31/89.[12] In light of their experiences with such provisions, some employers have come to regret either their approach for handling hardships under the 1988 Regulations or the very availability of hardship distributions. Since Section 411(d)(6) generally prohibits cutbacks in optional forms of benefit (including hardship distributions), employers were unable to alter their approach to hardships for existing account balances. New final Reg. 1.411(d)-4, A-2(b)(2)(x), however, permits employers to change or eliminate the availability of hardship distributions at any time.

Employers with plans that use the general hardship test may conclude that a catchall provision permitting distributions for any event determined to be a hardship by the plan administrator is again acceptable. Employers were forced to delete those provisions under the Section 411(d)(6) Regulations, because of the open-ended discretion granted to the administrator and the lack of objective criteria for determining a hardship. Government officials argue that catchall provisions still are not acceptable, even though an employer could make multiple plan amendments to achieve the same results. The same enthusiasm for formalities that led to the ban on restructuring may lead the Service to reject catchall provisions.

Amounts available for distribution. The final Regulations substantially revise the scheme for determining what is available for a hardship distribution. Prior to TRA '86, qualified matching contributions (QMACs) and QNECs were available for hardship withdrawal. The 1988 Regulations provided for the availability of elective contributions and pre-1989 earnings thereon, but prohibited hardship distributions of (1) post-1988 earnings on elective contributions and (2) QMACs and QNECs and earnings thereon.[13] The prohibition was retroactive in a sense, applying to amounts contributed in earlier years under plan rules that would have permitted such distribution.

Final Reg. 1.401(k)-1(d)(2)(ii) responds to the retroactivity concerns about the QMAC/QNEC rule, but cre-

ates a small, new cutback problem regarding earnings on elective contributions. Hardship distributions may be made from elective contributions, and any of the following that were credited to the employee's account as of the last plan year ended before 7/1/89:

1. Earnings on elective contributions.
2. QMACs and earnings thereon.
3. QNECs and earnings thereon.

The cutback problem arises in the following limited situation (ignoring short plan years). Under the old rule, a plan with a year ending after June 30 and before December 31 could make hardship distributions of amounts earned on elective contributions through 1988. Under the final Regulations, the plan may distribute amounts earned only through a date between 7/1/88 and 12/30/88, *i.e.*, the end of the last plan year ended before 7/1/89. A Government official has indicated informally that this will be corrected so that there will be no cutback.

What is hardship? Under Reg. 1.401(k)-1(d)(2)(i), hardship determinations are based on two criteria, each of which can be satisfied based on a safe harbor or a general facts-and-circumstances test.

1. An immediate and heavy financial need (*i.e.*, the nature of the expense). Despite employer entreaties to expand the safe harbor list, Reg. 1.401(k)-1(d)(2)(iv)(A) includes the same four types of expenses that the 1988 Regulations listed as posing an immediate and heavy financial need.[14]

Two of the safe harbors—medical expenses and college tuition—are expanded slightly in the final Regulations. Medical expenses include not only amounts "previously incurred," but also amounts "necessary . . . to obtain medical care." This will be helpful where up-front payments are required, as is often the case, for example, with orthodontia. If the patient can obtain medical care before payment, the Preamble states that the distribution may be made only after the expense is incurred.

Withdrawals for college tuition are no longer limited to the amount needed for the next semester or quarter, but now may extend to tuition and related educational fees for the next 12 months. The new reference to "related educational fees" might appear broad enough to cover room and board. The inclusion of room and board has been debated since the 1988 Regulations were published, and it was expected that any IRS decision would have been revealed unambiguously in the final Regulations. Government officials say, however, that the decision was made not to include room and board, and this technical defect in the final Regulations will be corrected.[15]

2. The distribution is necessary to meet the immediate and heavy financial need (*i.e.*, the expense relative to the participant's other resources). Generally, under Regs. 1.401(k)-1(d)(2)(iii)(B) and (iv)(B), the distribution may not exceed what is necessary to relieve the financial need. The final Regulations make it clear that this includes payment of Federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

The final Regulations do not ease the consequences of using the safe harbor to show that a distribution is necessary due to the amount of the expense and lack of other resources. For example, under Regs. 1.401(k)-1(g)(4)(i) and 1.401(m)-1(f)(4)(i), suspended participants still are eligible employees for purposes of testing the Section 401(k) arrangement for nondiscrimination. Also, Reg. 1.401(k)-1(d)(2)(iv)(B)(*4*) perpetuates the rule first stated in *Notice* 88-127, 1988-2 CB 538, precluding an employee who has taken a hardship withdrawal from making elective contributions to any qualified or nonqualified deferred compensation plan, including stock option, stock purchase, or similar plans. Compliance with the suspension rule is eased slightly, by an alternative to amending each plan to preclude participation by suspended participants; the safe harbor is satisfied if the employee is prohibited under a legally enforceable agreement from making contributions to any other plan. Employers should consider making such an agreement a condition to a hardship withdrawal.

In light of the continued rigidity of the safe harbor, several changes to the operation of the general test may encourage its use by employers. For example, under Reg. 1.401(k)-1(d)(2)(iii)(B), a distribution is not necessary if the financial need may be satisfied from the employee's other reasonably available financial resources. Employers worried that it might be unreasonable to rely on an employee's representation, and some sort of investigation into the employee's financial affairs would be necessary. The final Regulations permit reliance on an employee's written

[10] Regs. 1.401(k)-1(f)(4)(ii)(A), 1.401(m)-1(e)(3)(ii)(A), and 1.402(g)-1(e)(5)(i).

[11] For this purpose, employers are aggregated if they are treated as a single employer under Section 414(b), (c), (m), or (o).

[12] See Notice 88-127, 1988-2 CB 538.

[13] The rules reflected Congress' position that QMACs and QNECs were not available for distribution upon hardship. See Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 641.

[14] Generally, medical expenses, college tuition, purchase of an employee's principal residence, or prevention of eviction or foreclosure with respect to the employee's principal residence. An employer may list other expense categories in its plan, of course, but no safe harbor protection will be available.

[15] One Government official has suggested that "related educational fees" should be interpreted in light of Section 117(b)(2)(A), which excludes from income qualified scholarships, including amounts used for "tuition and fees required for the enrollment or attendance of a student," a fairly narrow category of expenses. If the Service adopts this standard, "fees, books, supplies, and equipment required for courses of instruction," covered in Section 117(b)(2)(B), would not qualify for a hardship withdrawal. Treasury Deputy Benefits Tax Counsel Petschek said, however, that additional guidance will reflect the Service's intention that "related educational fees" include any charges that are an integral part of education (e.g., laboratory or music room fees).

[16] Reg. 1.401(k)-1(d)(2)(iv)(B)(*2*).

[17] Both the Preamble to the final Regulations and the Preamble to the DOL loan regulations suggest that a more restrictive rule may apply where a participant's loan experience is shared by other participants. The DOL regulation imposes no limit on the availability of the 50% rule.

[18] 54 Fed. Reg. 30526 (1989).

[19] Prop. Regs. 1.401(k)-1(d)(1)(ii)(B) and (iii)(B).

[20] *Id.*

[21] See Sections 411(a)(11) and 417(e).

[22] See Sections 401(k)(2)(B)(i)(II) and 401(k)(10).

[23] Other requirements, unchanged from the 1988 Regulations, are not discussed here.

[24] Section 402(a)(6)(B)(ii), flush language.

[25] Sections 402(e)(4)(A)(i) and (iii).

representation provided that the employer has no *actual* knowledge to the contrary.

Under the general test, a participant need not turn to other resources where the effect of doing so would be to increase the participant's financial need (Reg. 1.401(k)-1(d)(2)(iii)(B), flush language). For example, an employee seeking to purchase a principal residence would not be required to obtain a plan loan if that would disqualify the employee from obtaining other necessary financing.

Another uncertainty about the general test was whether an employee had to exhaust all loan opportunities even if the loans, standing alone, would not cover the hardship. Reg. 1.401(k)-1(d)(2)(iii)(B)(*4*) provides that an employer must be satisfied that the need cannot be relieved by plan loans or commercial loans "in an amount sufficient to satisfy the need." There is some ambiguity as to whether the phrase applies to both plan loans and commercial loans or only to commercial loans; Government officials have offered inconsistent interpretations. If the phrase applies only to commercial loans, an employee would have to take out all available plan loans, of any size, and any commercial loan large enough to satisfy the need.

The safe harbor continues to require an employee to exhaust all available plan loans without regard to whether the loans fully relieve the hardship.[16] Because Department of Labor (DOL) Reg. 2550.408b-1(f)(2) generally limits loans to half the value of a participant's account, some employers were concerned that under the safe harbor participants could not get access to their full account balance on account of hardship where the Section 401(k) plan offered loans. The Preamble to the final Regulations notes that DOL applies the 50% limit only when the loan is made, and the remaining balance may be distributed immediately thereafter on account of hardship (DOL Reg. 2550.408-1(f)(2)(ii) is consistent with this interpretation). Accordingly, a participant has access to the full account balance.[17]

Participant loans from 401(k) plans. The Preamble to the final Regulations discusses the effect of a participant's default on a loan secured by a Section 401(k) account, and concludes that a mere default is not a distribution that would jeopardize qualification. Even though the default would subject the participant to taxation under Section 72(p) as if the loan were distributed, the default will not be a distribution for Section 401(k) purposes.

If an HCE participates in both the ESOP and non-ESOP parts of a 401(k) plan, separate ADP ratios are calculated for each part.

Under Reg. 1.401(k)-1(d)(6)(ii) (unchanged from the 1988 Regulations), the distribution occurs when the employee's accrued benefit is reduced because the plan has foreclosed on the loan. If the reduction occurs prior to a distributable event (*i.e.*, death, disability, separation from service, reaching age 59½, or hardship), the plan is disqualified. To protect plan qualification, an employer must delay foreclosure on a participant's account until a distributable event occurs. This, of course, raises the question of whether the loan is adequately secured. DOL has taken the position that where the loan is secured *solely* by the borrower/participant's account, reduction of the accrued benefit may be delayed well beyond default until the occurrence of a distributable event.[18] Where the loan default would negatively affect the investment experience of all participants' account balances, however, employers still face potential plan disqualification on loan default because here DOL would not permit a lengthy delay in reducing the participant's accrued benefit.

Special Circumstances

401(k) plan termination. Distributions on termination of a Section 401(k) plan are permitted only if the employer does not maintain or establish a successor plan. The Proposed Regulations reflected the broad definition of successor plan found in the statute, making it impossible for an employer that maintained *any* defined contribution plan (other than an ESOP) to offer distributions from a terminated Section 401(k) plan.[19] Although final Reg. 1.401(k)-1(d)(3) expands the circumstances in which distributions can be made by narrowing the definition of successor plan, the new rule is of limited value absent a change to other Regulations.

Under the final Regulations, an employer's other defined contribution plan precludes distributions from the Section 401(k) plan only if there is more than a minimal (2%) overlap in the employees "eligible" for both plans. For this purpose, under Reg. 1.401(k)-1(g)(4)(i), an employee who is currently entitled to make a contribution (including a pre-tax contribution) to or receive an allocation under a plan is eligible, even if the employee chooses not to participate. An employee not so entitled is not eligible, even if the employee has an account balance. The testing period for the 2% overlap is the 24-month period beginning 12 months before the Section 401(k) plan is terminated.

The final Regulations mitigate the consequences of violating the distribution rule where there is a successor plan. Under the Proposed Regulations, a distribution from a terminated Section 401(k) plan in the presence of a successor plan would disqualify not only the terminating arrangement but also the continuing plan.[20] Final Reg. 1.401(k)-1(d)(3) omits the provision disqualifying the continuing plan, and the Preamble makes clear that this omission was intentional.

Although the changes in the final Regulations are presumably intended to make it easier for an employer to make distributions from a terminated Section 401(k) plan, an employer still may have trouble "terminating" the plan because of the qualification requirement that a participant consent to any immediate distribution in excess of $3,500.[21] Reg. 1.411(d)-4, A-2(b)(2)(vi)(A), permits an employer to make distributions from a terminated plan without a participant's consent unless "the employer maintains any other defined contribution plan" (other than an ESOP). For this purpose, there is no limitation (such as the 2% overlap) on the definition of a successor plan. Regardless of whether eligible employees overlap with the 401(k) plan, an employer with any

other defined contribution plan may be unable to terminate the 401(k) plan. If termination is impossible, the more lenient rules under Section 401(k) are useless.

Business divestitures. Distributions may be offered to certain participants in a Section 401(k) plan where the sponsoring corporate employer sells or disposes of either (1) substantially all the assets used in a trade or business or (2) its interest in a subsidiary.[22] Unlike the rule permitting distributions on plan termination, which has only the 2% overlap limitation, this divestiture rule has a number of conditions. The final Regulations clarify some of the existing conditions, and add some new conditions to the rule's availability.[23]

1. Purchaser may not maintain the Section 401(k) plan. In a leap of logic necessary to make any sense out of the statute, the requirement that the seller must maintain the plan is interpreted by Reg. 1.401(k)-1(d)(4)(i) to mean that the purchaser may not maintain the distributing Section 401(k) plan. Thus, the plan may not (1) be adopted by the purchaser, (2) provide benefit accruals to the purchaser's employees, or (3) be merged with a plan maintained by the purchaser.

A purchaser's defined contribution (or even a Section 401(k)) plan will not prevent distributions by the seller's plan, even if it covers all the seller's former employees, unless the purchaser's plan is tainted by the seller's plan's assets. Rollovers from the seller's plan to the purchaser's plan would not cause a problem; direct transfers (treated as a merger) would. It is not clear whether "elective transfers" described in Regulations interpreting Section 411(d)(6) are rollovers or transfers/mergers for this purpose; a Government official has stated that elective transfers should be treated as rollovers. Although the final Regulations provide that an elective transfer will free the amount transferred from Section 401(k) distribution restrictions (leading one to believe that an elective transfer is like a rollover), a transfer is "elective" only if the amount could have been distributed at the time of transfer. If an elective transfer is a merger for purposes of the Section 401(k) sale rule, then no amount *could* have been distributed at the time of transfer. Clarification is needed because a single elective transfer would jeopardize the propriety of distributions from the seller's plan.

2. Deadline for distributions from the seller's Section 401(k) plan. Since the Proposed Regulations were issued in 1988, TAMRA added a rule permitting a distribution on Section 401(k) plan termination or on a sale only if the distribution is a lump sum received "by reason of the event." From this rule, final Reg. 1.401(k)-1(d)(4)(iii) has extrapolated a requirement that the distribution must be "in connection" with the sale or disposition. Absent special circumstances, this requirement will be met only if the distribution is made by the end of the second calendar year after the calendar year in which the disposition occurred. This rule parallels a requirement in the rollover rules that permits rollovers of distributions on a sale or disposition, but only if the distribution is made within the same time frame.[24] Nothing compelled the drafters to pick up the timing rule from the rollover provisions. A comparable requirement in the lump-sum rules that a distribution be "on account of" death or separation from service[25] has been interpreted to require nothing more than a distribution sometime *after* death or separation from service. That the timing rule was not applied to distributions on plan termination is somewhat puzzling. Assuming that the justification for the Regulation is the TAMRA requirement that distributions on plan termination or on a sale be made "by reason of the event," one would expect the rule to be the same in both situations.

Partnership 401(k) Plans

The Proposed Regulations' controversial positions on partnership arrangements are unchanged. By relaxing various effective dates, however, the Service has made compliance with those rules possible for partnerships that failed to respond to the 1988 Regulations.

Elective arrangements treated as CODAs. Generally, according to Reg. 1.401(k)-1(a)(6)(ii)(A), the right of a partner (or any employee) to opt out of a qualified plan or to elect a different level of contributions than are made on behalf of other partners or employees will transform an arrangement into a cash-or-deferred arrangement (CODA). Only if elections are one-time irrevocable elections made within certain time frames can such an arrangement avoid the $7,000 limit and the other rules applicable to CODAs. Following the 1988 Regulations, the Service set a deadline for partnership arrangements to either become qualified CODAs or to require employees and partners to make one-time irrevocable elections. For the many partnerships that failed to act within the time allowed, *Rev. Proc.* 91-47, IRB 1991-34, 10, offered a way to avoid disqualification provided certain conditions, including disgorgement of excess deferrals, were satisfied.

Timing of partnership elections. A second controversy involved the timing of partner elections. Reg. 1.401(k)-1(a)(6)(ii)(B) specifies that an election must be made by the end of the partnership's taxable year, the date for determining the partner's distributive share of partnership income. According to the Preamble, this rule is effective for plan years beginning after 1991, but the Regulation itself makes the rule effective for plan years beginning after 10/13/91. A Government official has said that the Regulation will be corrected to be consistent with the Preamble. Plans that give partners until the deadline for filing the partnership's Federal return to make an election may continue to do so for the 1991 plan year.

Matching contributions treated as CODA. The Service acknowledges in the Preamble that the provision in the 1988 Regulations that treated matching contributions on behalf of partners as elective contributions does not further its policy of parity between plans for employees and for the self-employed. Failing to find a solution to the problem, however, the Service has retained the rule from the Proposed Regulations while soliciting comments from taxpayers.

Plan Amendments

Any amendments that are needed to meet the minimum requirements of the final Regulations must be made by

the deadline for making the TRA '86 amendments. Other amendments, such as those liberalizing the hardship provisions, may be made at the employer's convenience.

402(g) limit. A plan must specify that the $7,000 (as adjusted) limit will be satisfied. To avoid possible disqualification, a plan maintained by an employer that is part of a controlled group should provide for distribution of excess deferrals.

ADP and ACP tests. Under the final Regulations, a plan must require that the Section 401(k) and (m) tests will be met, and the tests may be incorporated by reference. (The 1988 Proposed Regulations had required a plan provision for the Section 401(k) test, but not for the Section 401(m) test.) Collectively bargained plans must include the 401(k) test for the first time.

Gap period income. In correcting for excess amounts, a plan must specify whether gap period income will be included.

Section 415. A plan may provide for distributions of elective deferrals because of Section 415 violations.

Hardships. An employer may adopt the more liberal rules for making hardship distributions. □

PARTIAL TERMINATION DETERMINED BY ONLY COUNTING NONVESTEDS

A district court has taken issue with the Second Circuit as to which employees are counted in determining whether there has been a partial termination of a qualified plan. In *In re Gulf Pension Litigation*, 764 F. Supp. 1149 (DC Tex., 1991), the court held that only nonvested participants should be considered. This conflicts with *Weil v. Retirement Plan Administrative Comm.*, 933 F.2d 106 (CA-2, 1991), which included vested as well as nonvested participants in making the determination. (See "Who Will Count in Testing Partial Termination?," 75 JTAX 120 (August 1991).)

Merger of companies. To avoid a hostile takeover, Gulf merged with Chevron, which eliminated the need for many of Gulf's 23,000 employees. Of 8,500 employees subsequently terminated, only 2,100 were vested. Under Reg. 1.411(d)-2(b)(1), whether a partial termination occurred depends, in part, on whether a major corporate event (here, the merger) resulted in a significant reduction in the work force.

In *Gulf*, the court held that the partial termination rule was intended to prevent both of the following:

1. Nonvested pension benefits from being forfeited.

2. An employer windfall from the reversion of contributions on which the employer never paid taxes.

The court held that in making this determination, only nonvested terminations were relevant. It did, however, also make the calculations including vested employees and concluded the results would have been the same.

Contrast with *Weil*. In *Weil*, on the other hand, the court held that Congress intended the partial termination to be applied to a sudden and dramatic change in the plan as a whole. There is no distinction in the legislative history between vested and nonvested plan participants. This was buttressed by language in the Regulations that refers to exclusion of covered employees.

Gary Quintiere, a partner in the Washington, D.C., office of the law firm of Morgan, Lewis & Bockius and frequent commentator in the qualified plan area, suggests that the *Gulf* approach is the better one. He notes that the partial termination rules have to be read in conjunction with ERISA Section 510, which requires an individual who thinks he was discharged so as to prevent him from vesting to sue his employer and prove it. Mr. Quintiere suggests that under the *Weil* approach, where a significant percentage or number of employees is fired and only one is nonvested, that one will automatically vest. The two situations should not yield different results for the sole nonvested employee. To require vesting only when a significant number of nonvested employees are discharged would better fit the purposes of the partial termination rules and ERISA Section 510. □

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