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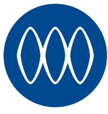

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Before Cashing Out, Plan Sponsors Must Consider Automatic Rollover Roulette

by Dominick Pizzano and Dawilla Madsen

When it came to cashing out benefits of participants in qualified retirement plans who terminated employment before the later of age 62 or normal retirement age, the compliance rules under the tax code used to be simple. They enabled the plan sponsor to distribute the participant's entire benefit as soon as practicable following the date the participant walked away from the employment table, provided that the value of such benefit was $5,000 or less. Neither participant nor spousal consent was required. And unless the participant elected a direct rollover to an individual retirement arrangement (IRA) or other eligible retirement plan, a check could be cut for the entire amount less tax withholding and mailed to the participant's most current address on file.

Most plan sponsors took advantage of this "mandatory cashout" rule as a way to minimize administrative expenses by not having to maintain small benefits in the plan. The savings were even greater for defined benefit plans, because the plan sponsor would otherwise have to continue to pay annual premiums to the Pension Benefit Guaranty Corporation each year that the participants remained in the plan. In addition, these mandatory cashouts provided perhaps the best chance of getting the money into the hands of the terminated employee before he or she had the opportunity to slip off into the land of the lost participants.

The Raised Compliance Stakes

The 2001 tax law and the issuance of subsequent guidance from both the Department of Labor (DOL) and the IRS have complicated the compliance efforts of plan sponsors with mandatory cashout provisions in their plans. Under the new rules, plan sponsors can still get the terminated participant's benefit out of the plan if it is $5,000 or less without obtaining the participant's or spouse's consent. Rather than just cutting the check and dropping it in the mail, however, the plan sponsor must roll over the cashout to an IRA if the amount being distributed is greater than $1,000, unless the participant makes an affirmative election to receive it in cash or directly roll it over.

Is Automatic Rollover Roulette a Must-Play?

The automatic rollover rules not only apply to all qualified defined contribution and defined benefit plans, but also to 403(a) plans, 403(b) plans, and certain 457(b) plans (i.e., those of state or local governments but not those of other not-for-profit entities). Oddly, even though the tax code's mandatory cashout rules do not otherwise apply to qualified plans maintained by governmental employers and nonelecting church plans, the new automatic rollover rules cover these plans. This is quite an unlucky result because such plans are not subject to the federal law (ERISA) governing employee benefits and thus they are not able to protect themselves from liability under local laws by complying with the DOL guidance discussed later.

As the plan sponsor, however, you are not required to comply with the automatic rollover provisions if you have one of the relatively few plans that does not include mandatory cashout provisions.

If your plan does contain these provisions, there are four basic options for developing a winning strategy for conforming to the new rules. (See also, Table 1 on p. 3 for additional "tips.") Regardless of which option you select, any cashouts that occur on or after March 28, 2005, must be processed in accordance with the methodology of that option. The IRS guidance permits you to suspend mandatory cashouts until December 31, 2005, to allow for time to establish policies and procedures for making automatic rollovers. After you select your option, your plan must be formally amended to incorporate the option by the last day of the first plan year ending on or after March 28, 2005 (e.g., December 31, 2005, for calendar year plans). Certain governmental and church plans, however, will not be required to comply until sometime in 2006, depending on the date of the close of the legislative session or church convention, whichever is applicable.

Option 1. Eliminate the mandatory cashout provision. Under this option, participants may be permitted to take a distribution in any form and at any time permitted under the provisions of the plan without their spouse's consent, provided the value of their benefit is $5,000 or less. However, they must be permitted to defer their benefit under the plan until the later of age 62 or their normal retirement date.

This option allows you to avoid spinning your wheels trying to deal with the ERISA fiduciary and administrative responsibilities associated with automati-

cally rolling over mandatory cashouts to IRAs. While this is certainly the simplest and most straightforward approach, plan sponsors may view it as a losing bet if a considerable number of terminated participants who would have otherwise been automatically cashed out do not take their benefits with them but instead "let it ride" in the plan, and thereby create a corresponding increase in the plan's expenses. Fortunately, defined contribution plan sponsors now have the option of offsetting this cost by charging fees to maintain the account since both the IRS and the DOL recently sanctioned the charging of reasonable fees to terminated participants in defined contributions plans under certain circumstances.

Option 2. Reduce the mandatory cashout threshold to apply only to cashouts of $1,000 or less. As with option #1, this choice allows you to avoid the additional fiduciary duties and administration associated with automatic rollovers. Spousal consent is not required for benefits of $5,000 or less and participants must be permitted to defer their benefit under the plan until the later of age 62 or their normal retirement date, if the value of the benefit is greater than $1,000. With this approach, you at least retain some ability to force out very small benefits of former participants. However, for cashouts greater than $200, the option of electing a direct rollover must still be offered to participants

One of the factors that defined contributions plan sponsors should bear in mind is that prior rollover contributions must be included when determining the $1,000 (or less) limit. Therefore, to avoid the automatic rollover provisions, prior rollover contributions could be included in determining the mandatory cashout limit. This is typically not an issue in a defined benefit plan because most do not accept rollovers.

Option 3. Retain the mandatory cashout provision and apply the new rules to all cashouts of $5,000 or less. The DOL guidance extends the availability of applying the automatic rollover provisions to all mandatory cashouts, including those of $1,000 or less. So if you are a plan sponsor that wishes to up the ante, this option subjects all mandatory cashouts of $5,000 or less to the automatic rollover rules. As a result, in each case where you are not able to obtain the participant's consent to a mandatory cashout, an automatic rollover must be made. The IRS guidance confirms that the plan administrator may select a financial institution with which it can establish the IRA on behalf of the participant, using the participant's last known mailing address.

Under this option, the plan administrator will no longer retain any fiduciary liability with respect to the terminated participant; there will be no further cost in maintaining the benefit under the plan; and the burden of keeping in contact with the former participant will be shifted to the IRA provider.

Plan sponsors should keep in mind that even though most mandatory cashout rules apply regardless of the participant's age, cashouts made after the later of age 62 or normal retirement age are not technically "mandatory cashouts." This means that the DOL safe harbor rule discussed below technically does not protect post-age 62/normal retirement age mandatory cashouts. This oversight might be addressed in future guidance.

Option 4. Retain the mandatory cashout provision and apply the new rules to only cashouts that are greater than $1,000 but not greater than $5,000. This option is actually a combination of options #2 and #3 in that while all cashouts within the designated dollar amounts are subject to the automatic rollover rules, you at least retain some ability to force out very small account balances of former participants instead of having to retain them in the plan.

Strategies to Help Even the Odds

Timing is everything: It is important to remember that the new rules only apply to the timing of the payment—not the form. While you can no longer force an immediate lump-sum cashout of greater than $1,000 without providing the automatic rollover provisions, you can still force a distribution of $5,000 or less to be in the form of a lump sum with no participant or spousal consent required as long as the participant is permitted to defer receipt of the lump sum until the later of age 62 or normal retirement age. However, if the value of the benefit grows to beyond $5,000 by the time the participant elects to have it paid, an automatic lump sum without participant and spousal consent is not available and the terms of the plan must be reviewed to determine the appropriate form of payment.

Best Bets for Avoiding Hassles: The selection of options #1 or #2 gives plan sponsors the best odds of operating their plan in much the same manner as they always have. That is, chances are that most lump sums of $5,000 or less will still be cashed out because the majority of participants jump at the chance to cash in their benefit chips all at once. The only difference is that participant consent is required for all cashouts for option #1 and cashouts of greater than $1,000 for option #2.

You Bet Your Life: Upon the death or divorce of the participant, chances are that an individual has been designated to receive the benefits payable from the plan. (A payment to the participant's estate is usually a long shot.) However, the automatic rollover rules only apply to participants—not to spouses, other beneficiaries, alternate payees, or the estate. Therefore, plans may continue to automatically distribute a benefit of $5,000 or less if the benefit is payable to a recipient other than the participant. Of course, some plan sponsors may view having more than one mandatory cashout limit as an extra administrative burden that outweighs the advantages of the opportunity for additional mandatory cashouts. For such sponsors, the rules accommodatingly supply the option of applying a $1,000 mandatory cashout limit in all cases.

Making a Safe Bet

If option #3 or #4 is the best bet for you, the DOL's final regulations give you four safe harbors to cover your compliance wagers:

1. The automatic rollover must be a direct transfer to an IRA. IRS guidance indicated that for purposes of the automatic rollovers, IRAs include deemed IRAs (i.e., a separate IRA account established within the qualified plan from which the distribution is being made). However, because deemed IRAs are not specifically included in the DOL guidance, how and if the DOL safe harbor protections will apply are unclear.

2. The plan sponsor or other fiduciary must enter into a written agreement with one or more IRA providers ensuring that: the rollover is invested in a product designed to preserve principal and provide a reasonable rate of return consistent with liquidity (i.e., the return does not have to be guaranteed) which seeks to maintain, over time, the initial dollar amount invested; the investment product is offered by a state or federally regulated financial institution (e.g., bank, insurance company, or mutual fund company); fees and expenses do not exceed those charged by the provider for comparable IRAs established for reasons other than automatic rollover; and the participant has the right to enforce the terms of the IRA agreement once the automatic rollover has taken place.

   Once the agreement is signed, the plan sponsor is not required to monitor the IRA provider's compliance with the terms of the agreement.

3. The plan fiduciary must not engage in a prohibited transaction when selecting the IRA provider or when determining the investments under the IRA. For example, a plan sponsor could not accept a fee for selecting one IRA provider over another.

4. Prior to the date of any mandatory cashouts, the participant must be furnished a summary plan description (SPD) or summary of material modifications (SMM) that describes the automatic rollover requirements, including how the rollover will be invested, and indicates how fees and expenses attributable to the IRA will be paid. In addition, if the SPD does not already do so, it must provide the name, address, and phone number of the plan contact who can provide further information regarding the automatic rollover provisions, IRA provider, and fees.

In addition to the SPD or SMM required by the DOL, the IRS guidance requires a plan administrator to notify the participant in writing (whether via hardcopy or electronic media) no later than 30 days and no earlier than 90 days prior to the distribution date that, absent an affirmative election by the participant, the cashout will be paid to an IRA. The notice may be delivered either separately or as part of a special tax notice and must identify the trustee or issuer of the IRA.

The Deadline Wheel is Spinning

Plan sponsors with calendar year plans have until December 31, 2005, to officially document their strategy for playing automatic rollover roulette or

TABLE 1

PLAN SPONSOR TIP SHEET FOR PLACING AUTOMATIC ROLLOVER BETS	
ACTION	**LATEST DATE TO COMPLY**
Choose one of the following options: 1. Eliminate the current mandatory cashout provision 2. Reduce the current mandatory cashout provision to $1,000 3. Apply rollover rules for lump sum cashouts of $5,000 or less 4. Apply rollover rules for lump sum cashouts of greater than $1,000 to $5,000	March 28, 2005, or December 31, 2005, if mandatory cashouts are suspended
If Option 1 or 2 is Elected	
Revise cashout election forms	Before any mandatory cashouts are made
Distribute SPD or SMM	Preferably before cashouts are made, but not required until 210 days following the end of the plan year in which the amendment is adopted, or effective if earlier
Amend Plan	Last day of first plan year ending on or after March 28, 2005
If Option 3 or 4 is Elected	
Distribute SPD or SMM	March 28, 2005, or before any mandatory cashouts are made, if later
Provide Automatic rollover notice (revise current 402(f) notice or provide separate notice)	With election form (30-90 days prior to cashout date)
Revise cashout election forms	Before cashout is made
Find IRA provider and sign written agreement	Before any mandatory cashouts are made
Amend plan	Last day of first plan year ending on or after March 28, 2005

eliminating their mandatory cashouts to avoid dealing with the new rules. Most defined benefit plan sponsors are choosing options #1 or #2 since they are the closest to the status quo and the hassle of finding a rollover provider is avoided. On the other hand, many defined contribution plan sponsors are electing options #3 or #4 since they already have a relationship with an IRA provider, namely their recordkeeper or trustee, that can make the transfer of funds to an IRA relatively seamless. Depending on the strategy adopted, there may still be many operational procedures to check. However, since compliance with these new rules is a plan qualification issue, you should not gamble on the outcome. If you have not already done so, you should contact benefits professionals to review your current document and administrative procedures. They can help you analyze your options based on the applicable factors such as plan document type, employee turnover, and plan expense structure. Once you have made a decision, they can help you make the necessary changes to your plan so that you are guaranteed to have a winning result when the deadline wheel comes to a stop.

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Providing Paid FMLA Leave Through Short-term Disability Insurance

by Robert W. Beal

The Family and Medical Leave Act (FMLA) is estimated to have helped 35 million Americans take up to 12 weeks of job-protected leave. The fact that the law does not require employers to provide compensation during such leave, however, is viewed by many as a serious shortcoming.

Paid FMLA leave might increasingly become a common employee benefit as more states mandate it, labor unions successfully bargain for it, and employers seek to improve the benefits they offer. To meet this need, paid FMLA leave could become an insured employee benefit much like health, life, and disability benefits, which are provided through insurance contracts. This article explores the considerations and potential cost of expanding short-term disability insurance coverage to provide for paid FMLA leave.

Interest in Paid FMLA

The FMLA, enacted in 1993, provides up to 12 weeks of job-protected unpaid leave during any 12-month period for covered and eligible employees due to their own health, childbirth, care for a new child, and care for a seriously ill child, spouse, or parent. (See sidebar for a summary of the FMLA's provisions.)

In the case of leave due to an employee's own health or maternity needs, sick pay and short-term disability insurance are available to 59% and 39% of US workers, respectively, according to a study by the US Bureau of Labor Statistics. For other types of FMLA leave, employees may have to use vacation pay if they want to receive any compensation. But receiving compensation while taking FMLA leave is not an option for many workers, with a national study finding that 78% of workers who wished

Family and Medical Leave Act of 1993

Provisions:
The Act provides covered and eligible employees up to 12 weeks of job-protected, unpaid leave during any 12-month period for the following reasons:

- the employee's own serious health condition, including pregnancy and childbirth;
- the employee's need to care for a new child (new born, adopted, or foster);
- the employee's need to care for a seriously ill child, spouse, or parent.

Job Protections:
The FMLA protects an employee's job, seniority, and health benefits during leave for any of the stated reasons.

Covered Employers:
Covered employers include all public-sector agencies (federal, state, and local) and private-sector employers that have at least 50 workers within a 75-mile radius.

Eligible Employees:
To be eligible for leave under the FMLA, a worker must be an employee of a covered employer for at least 1,250 hours over the 12 months preceding the leave.

Preemption of State Laws:
State and local laws providing greater leave rights than those provided in the FMLA are not preempted by the FMLA or any other federal law, including the Employee Retirement Income Security Act (ERISA).

to take FMLA leave chose not to primarily because they simply could not afford to take unpaid leave.

Some labor unions have successfully bargained for employees to receive paid FMLA leave. In addition, coalitions of labor unions and advocates of family, women, and child care are striving to have state legislation passed that will require employers to provide paid FMLA leave. In 2004, California adopted the country's most comprehensive paid FMLA programs by expanding its State Disability Insurance (SDI) program to include FMLA leave. Currently, both New York and New Jersey have pending legislation that seeks to extend their own SDI programs to cover FMLA leave.

TABLE 1

Estimated Annual Premiums Per Employee for FMLA Leave (7-day Waiting Period and 12-Week Maximum Benefit Period; Compensation = 50% of Weekly Pay with $500 Maximum)

FMLA Leave	Male	Female
Own Health and Childbirth	$125.67	$288.23
Care for New Child	$5.66	$52.31
Care for Ill Child	$0.57	$5.95
Care for Ill Spouse	$0.48	$11.55
Care for Ill Parent	$8.73	$14.00
Total Premium – Excluding Own Health and Childbirth	$15.44	$83.81
Total Premium – Including Own Health and Childbirth	$141.11	$372.04

Expanding Short-term Disability Insurance

Expanding traditional short-term disability coverage is a potential and natural means to providing paid FMLA leave coverage. However, there are two key questions that insurers must investigate before taking this approach:

Is FMLA leave a random event?

For any insurance product, the covered risk must represent a random event for which the insured suffers a financial loss. The amount of control that the insured might exercise over this risk and the potential for a greater chance of loss than contemplated by the applicable insurance rate (i.e., anti-selection) must be minimized, if not eliminated.

Under short-term disability coverage, the condition causing the disability must prevent the employee from performing the duties of his or her occupation. Such a requirement may not be defined as easily for an employee's child, spouse, or parent. However, practices and requirements already set up by employers to administer the FMLA provisions can offer protections to employers against employees who try to misrepresent or overstate the seriousness of the circumstances for requesting leave. For example, some employers require a doctor's certification that a child, spouse, or parent is ill and requires care from the employee before the employee is granted FMLA leave.

Is the cost of paid FMLA manageable and affordable?

Product design is instrumental in controlling claim costs and minimizing anti-selection. For disability insurance, limiting the benefit to 50%-60% of the employee's earnings with an appropriate maximum weekly benefit and requiring a reasonable waiting period and maximum benefit period are critical to controlling claim costs. A seven-day waiting period before receiving the paid benefit is common for short-term disability coverage. The maximum benefit period for FMLA leave could coincide with an employer's short-term disability benefit period or may equal the 12 weeks provided in the FMLA, if less. At a minimum, these features may need to satisfy any terms mandated by the state laws or labor union contracts.

Effective administrative practices for reviewing and approving requests for leave also are important. Paying no compensation to leave-takers may have a self-controlling effect over potential over-utilization, because employees may be less likely to request FMLA leave except for unavoidable emergency situations. With paid FMLA leave benefits, closer scrutiny of requests for leave may be required.

Estimating the Cost of FMLA Leave

Because paid FMLA leave is not currently available as an insurance product, insurance companies that want to offer such coverage must develop their premium rates based on data gleaned from external sources. A key source of data for estimating the cost of paid FMLA leave is the 2000 Survey of Employees and Establishments, conducted by the bipartisan Commission on Family and Medical Leave. This study, which is conducted every five years, provides significant data on leave utilization and length of leave.

The leave-takers who responded to the survey generally did not receive paid compensation while on leave except for what may have been available through vacation time, sick pay, or short-term disability benefits. Thus, average utilization of FMLA leave can be expected to be higher and the duration of leave longer for employees receiving compensation during FMLA leave than the average results reflected in the survey.

To model the estimated potential cost of paid FMLA leave, the following factors should be taken into account:

- results from the 2000 survey of employees and establishments;
- estimates of the impact of receiving paid leave on the average utilization and duration of leave from the 2000 survey of employees; and
- distributions of the working population by age, sex, and annual salary/wage based on the US Census Bureau data.

Table 1 illustrates the estimated annual premiums per employee of the various types of FMLA leave by gender, based on an actuarial model incorporating the above factors. FMLA leave for an employee's own health or maternity leave shown in Table 1 is often covered by traditional short-term disability benefits.

The benefits reflected in the table assume a seven-day waiting period, a 12-week maximum benefit period, and a weekly benefit equal to 50% of an employee's weekly pay subject to a $500 weekly benefit limit. In addition, the illustrated premiums assume the claim costs are 60% of the premium, with the remainder going toward the insurer's expenses and profits.

The premium rates in Table 1 are hypothetical. They are not based on actual paid FMLA experience since few, if any, insurers currently provide coverage for paid FMLA leave outside of the traditional short-term disability coverage. There is a high likelihood that actual paid FMLA costs for a specific employer could vary significantly from those assumed in the premium rates in Table 1. However, these premium rates illustrate the potential cost of paid FMLA leave, as well as how such costs could possibly vary among the various types of leave and gender. Traditional short-term disability benefits for females are typically two to three times the cost of comparable benefits for males. Based on the results in Table 1, the cost of paid FMLA leave for female workers could be five times the comparable cost for male workers since the burden for the types of care giving reflected in the FMLA leave often falls disproportionately upon the female working population.

The cost of expanding short-term disability coverage to include all forms of FMLA leave within the hypothetical plan represented in Table 1 increases male premiums by approximately 12% and female premiums by 29%. As with short-term disability coverage, the premiums could be paid by the employer or the employee or shared between the two. For example, the paid FMLA benefits mandated in California are paid fully by employees.

Conclusion

State mandates and labor union negotiations have already begun to exert pressure on employers to provide paid FMLA leave. The potential costs for providing these benefits are material but not necessarily overwhelming in relation to the cost of short-term disability coverage. Paid FMLA leave may represent an opportunity for insurance companies, particularly disability carriers, to expand their offerings of insured employee benefits and provide a valuable product to employers.

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What 401(k) Plan Sponsors Need to Know Before January 2006

by Tara Silver-Malyska

Late last year, the IRS issued final regulations for defined contribution retirement plans that contain cash-or-deferred arrangements (CODAs) or matching or employee contributions under tax code sections 401(k) and 401(m). Although the IRS primarily consolidated and updated rules to reflect statutory changes and related guidance since 1994, the final rules contain some significant modifications. Because the final rules are generally effective for plan years beginning after January 1, 2006, affected plan sponsors need to know how the changes will affect their retirement plans.

This article provides an overview of the final rules and focuses on the key areas that employers should consider.

No Bottom-Up Leveling QNECs

An employer may correct a failure of the actual deferral percentage (ADP) test by making additional qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) for nonhighly compensated employees (NHCEs). Prior to the effective date of the final regulations, plan sponsors commonly corrected a failure of the ADP test through "bottom-up leveling." Under this methodology, the employer reduces its total QNEC contributions by first allocating QNECs to the lowest-paid NHCE, then to the next lowest-paid NHCE and so on, until the plan passes the ADP test. The final rules eliminate this correction method by adding a requirement for inclusion of QNECs exceeding 5% of compensation in the ADP test.

If the QNEC is greater than 5%, the employer may only take the amount into account for the ADP test if the QNEC contribution passes a test that compares the QNECs of all NHCEs. Specifically, a QNEC that is greater than 5% may only be counted in the ADP test if it does not exceed two times the plan's representative contribution rate (i.e., in general, the lower of the rates—consisting of QNECs and QMACs—received by either: half of all eligible NHCEs; or all eligible NHCEs employed on the last day of the plan year). For example, an employer making a $1,000 QNEC on behalf of an NHCE with compensation of $15,500 must reduce the QNEC to $775 or increase the QNECs made to other NHCEs to ensure that the plan's representative contribution rate is at least half of 6.45% in order to include the QNEC in the ADP test.

Similar restrictions apply for including QNECs exceeding 5% in the actual contribution percentage (ACP) test. Because QNECs of less than 5% of compensation are not subject to the new restrictions on targeting QNECs, a plan may take into account up to 10% (i.e., 5% in the ADP test and 5% in the ACP test) in QNECs without applying the new restrictions. QNECs cannot be double counted for both the ADP and ACP tests (including calculation of the representative contribution rate).

Other Nondiscrimination Rules

Other key nondiscrimination requirements addressed by the final regulations include:

- *Targeted Matching Contributions.* A similar restriction on matching contributions exceeding 5% of compensation applies for purposes of the ACP test. A plan may not take into account matching contributions under the ACP test if they exceed the greater of 100% of the employee's elective deferrals for a year, or two times the plan's representative matching rate. The representative matching rate determination is parallel to the targeted QNEC calculation described above, but uses an employee's matching contributions divided by elective deferrals. For example, if NHCE matching rates were 50%, 50%, and 400%, the lowest matching rate is 50%. Therefore, the match of 400% is more than twice the plan's representative matching rate, as well as greater than 5% of compensation, and thus the full amount of the matching contribution cannot be taken into account in the ACP test. If the matching rate is not the same for all elective deferrals, it is calculated using 6% of compensation.

- *Aggregation and Disaggregation of Plans.* The final rules permit an employer to aggregate or disaggregate the employee stock ownership plan (ESOP) portion and non-ESOP portions of a single plan for ADP and ACP testing. Employers must use a single testing method for all CODAs under a plan, i.e., aggregating a current-year testing plan with a prior-year testing plan is prohibited. Furthermore, a plan that applies the ADP test may not be aggregated with a plan that uses the ADP safe harbor. If a plan is divided into separate entities under the tax code's minimum coverage requirements, each separate plan may apply a different testing method.

- *Income During the Gap Period.* A plan that corrects a failure of the ADP or ACP test by distributing excess elective and aggregate contributions must also distribute related income, as well as income for the "gap period," i.e., the period after the plan year prior to the date of the distribution. The final rules clarify that the gap period income is required only if the employee is actually credited with gains or losses on those excess contributions and need not include income for the seven days prior to distribution. In addition, if excess contributions are distributed, they are includible in income when the employee would have received those amounts in cash. For example, if the plan year is a calendar year and the employer elects to correct a test failure for 2005 by distributing excess contributions in 2006, the distribution plus the income thereon is treated as 2005 income by the employee.

No Prefunding of Contributions to Accelerate Deductions

The final rules provide that a contribution is made pursuant to a CODA election only if the contributions are made after the election is made and after the employee has performed services that gave rise to the compensation from which the deferral is to be made. Accordingly, amounts contributed in anticipation of future performance of services are not treated as elective contributions and an employer may not prefund elective contributions to accelerate the deductions for elective contributions. There are two exceptions to the rule: (1) occasional bona fide administrative considerations (e.g., the temporary absence of the bookkeeper responsible for transmitting funds to the plan) that do not have a principal purpose of accelerating deductions; and (2) compensation paid prior to the performance of services. Similar rules apply for matching contributions.

Hardship Withdrawals

A hardship withdrawal distribution requires an employee to meet two basic requirements: the employee must have an immediate and heavy financial need; and the distribution must be necessary to satisfy that need. There are statutory safe harbors for which expenses will automatically meet the "immediate and heavy financial need" test (e.g., medical expenses of the employee, spouse, or dependent children; purchase of a principal residence for the employee; certain tuition and related educational expenses; or to prevent eviction from or foreclosure of the employee's principal residence). The final rules clarify that a safe harbor hardship must also separately satisfy the requirement that a distribution "is necessary to satisfy" the immediate and heavy financial need. The rules also clarify that the requirement that a participant first obtain all distributions currently available under all qualified plans of the employer in order to qualify for a hardship distribution applies equally to a distribution of an ESOP dividend. In addition, the final rules include in the list of events that are deemed to be immediate and heavy financial needs: payments for burial or funeral expenses for the employee's deceased parent, spouse, children, or dependents; and expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction (determined without regard to whether the loss exceeds 10% of adjusted gross income).

Safe Harbor Plans

The final rules incorporate current guidance and also provide a design-based safe harbor for CODAs to satisfy the ADP test by complying with certain contribution and notice requirements. In general, an employer must adopt a safe harbor plan before the beginning of the year and maintain the plan throughout a full 12-month plan year. There are exceptions to this rule:

- a short first plan year,

- short plan years due to: 1) a plan termination in connection with a merger or acquisition or substantial business hardship; or 2) a plan termination if the employer makes the safe harbor contributions through the termination date, provides employees notice of the change, and passes the ADP test; and

- a short plan year, resulting from a change of plan year, that is preceded and followed by a 12-month plan year that satisfies the safe harbor.

Miscellaneous Items

The final rules also:

- permit automatic enrollment, in the absence of an affirmative election by an employee, and allow employers to select a specific default contribution percentage;

- place limits on when a plan may switch from using current-year testing method to prior-year testing method;

- make elective contributions immediately nonforfeitable and taken into account under the vesting and service-crediting rules;
- establish an anti-abuse rule that prohibits a plan from making repeated changes to its testing procedures or adopting provisions that have the effect of distorting the ADP or the ACP so as to increase significantly the permitted ADP for highly compensated employees (HCEs);
- provide that a change in status from employee to leased employee is not a severance of employment resulting in a distributable event;
- allow for early participation testing where a plan may perform the ADP test by either: comparing the ADP for all eligible HCEs and eligible NHCEs, excluding all NHCEs who have not met the minimum age and service requirements; or disaggregating the plan into two separate plans and completing the ADP test separately for all eligible employees meeting the minimum age and service requirements and for employees not meeting these requirements;
- determine the actual deferral ratio and actual contribution ratio for each HCE participating in more than one CODA by aggregating the HCEs' elective contributions that are within the plan year of the CODA being tested, using 12 months of elective contributions and 12 months of compensation; and
- expand the list of defined contribution plans that an employer may maintain after terminating the CODA while still providing for distribution of elective contributions upon plan termination to include not only an ESOP or Simplified Employee Pension, but also a SIMPLE IRA, a 403(b) tax-sheltered annuity, or a 457 deferred compensation plan.

Preparing for January 2006

Plan sponsors should recognize that plan amendments to comply with the final rule changes are necessary. Whether the IRS will permit plans to operate in compliance with the rules and be amended at a later date or require plan amendments by January 1, 2006, remains unclear. The agency has not issued model amendments to implement these changes. The final rules will also require modifications to administrative policies and procedures, as well as employee communications (e.g., summary plan descriptions and enrollment packets) and forms (e.g., for hardship withdrawals). Although the IRS recently issued proposed rules for qualified plan notices, elections, or similar communication in electronic form, employers may not rely on them until they become final.

Much of the final rules affect nondiscrimination testing and thus have direct implications for recordkeeping systems and third-party administrators (TPA) responsible for the plan. Thus, plan sponsors not only need to be familiar with the rules, they also must ensure that the TPA and plan systems accurately operate under the final rules.

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