KRAVITZ
LOUIS KRAVITZ & ASSOCIATES INC

Information Release

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New 401(k) Rules Become Effective in 2006

New regulations go into effect in 2006 that will affect most 401(k) plans. In many cases, the new rules may require plan amendments and may increase the cost of correcting nondiscrimination test failures.

Here are just a few of the changes brought about by the new regulations.

Qualified Nonelective Contributions ("QNECs")

Most 401(k) plans must satisfy an ADP (Actual Deferral Percentage) test. This test was designed to assure that the contributions made by highly compensated employees bear a reasonable relationship to contributions made by employees who are not highly compensated. At the end of each year, this test is performed on all employee deferrals. If the test is failed, the employer has several options.

One corrective step an employer can take is to refund contributions to highly compensated employees. This is often the least desirable option. Other options are available that might prevent the need for refunds.

One commonly used option is making Qualified Nonelective Contributions ("QNECs"). Simply put, this means that the employer can make contributions on behalf of employees who are not highly compensated. These contributions can be included in the ADP test to help it pass.

For 2005 and prior years, a plan has wide latitude in how it allocates these QNECs (subject to certain maximum limits). Usually a plan provides that they are made on behalf of the lowest-paid participants in whatever amounts are needed to pass the ADP test. The new regulations require the plan to limit the amounts of these contributions or expand the group of employees who receive them. The bottom line is that it may become much more expensive to use QNECs to help pass the ADP test for plan years beginning after December 31, 2005.

Gap Period Income

Sometimes plans are required to make refunds to highly compensated employees to correct an ADP or ACP test failure. The new regulations require that in making these refunds, income must be included for the "gap" period (the period from the end of the plan year being tested to the refund distribution date) if the plan otherwise would have credited a participant's account with income for this period. The new rules provide for a seven day grace period for the valuation date to be used. For example, if corrective distributions are made on April 30, those distributions could include gap period earnings which are based on a valuation date that is not earlier than April 23. The new timing requirement will add an additional sense of urgency to this administrative rule.

The rules contain a safe harbor method of determining gap period earnings. Under the safe harbor method, the earnings are equal to 10% of the actual plan year earnings for each month of the gap period. If distributions are made not later than the fifteenth day of a month, that month need not be counted.

This provision will be effective in 2007 for refunds made on account of the 2006 plan year.

Expanded Safe Harbor Hardship Criteria

Many 401(k) plans allow participants to make withdrawals for financial hardship. The new regulations add two items to the list of events that automatically qualify as "financial hardships."

- √ Burial or funeral expenses for the employee's deceased parent, spouse, child or dependent; and
- √ Expenses for repair of damage to the employee's principal residence that would qualify as deductible casualty expenses (without regard to the 10% floor for deductibility).

Most plans will need to be amended if they wish to incorporate these additional hardship events.

Effective Date

The new regulations apply to plan years beginning after December 31, 2005. Since many plans operate on a calendar year basis, this means the new rules go into effect January 1, 2006. An employer can elect to comply with the new regulations sooner provided that the plan complies with the regulations in their entirety. It is not possible to elect early compliance with one portion of the regulation but not others.

What Kravitz is Doing

We at Kravitz are taking several steps to help our clients comply with the new regulations.

- √ We are reviewing our clients' plans to determine which plans are affected by the QNEC issues and what their options might be.
- √ We are modifying our hardship withdrawal forms and will post the revised forms to our website by December 15, 2005.
- √ Once IRS guidance is issued, we will prepare any required plan amendments for those clients for whom we perform document services.
- √ If, under the new rules, refunds are to be made, we will assist with the calculation of the Gap period income.

What You Need to Do

If you have questions about the new 401(k) regulations, you should contact your Kravitz consultant to discuss your 2006 options by October 31, 2005. In particular, you should contact your Kravitz consultant if your plan uses QNECs to pass its ADP test.

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