

**FINAL 401(K) REGULATIONS  
CLIENT MEMORANDUM**

**To:** Hinkle Elkouri Law Firm L.L.C. Employee Benefit Plan Clients  
**Date:** August 25, 2006  
**Re:** Final 401(k) Regulations - *Action Will Be Required on Your Part*

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In December, 2004, the Internal Revenue Service issued final 401(k) regulations. These regulations replace regulations that were issued in 1994. For the most part, the new regulations merely update the old regulations to reflect a number of changes that have taken place in the law between then and now, but there are also a few substantive changes. As discussed below, *the IRS has set a deadline for all 401(k) plans to be updated for these final regulations.* Action will be required on your part, even if you are not directly affected by any of the changes made by the final regulations.

**I. - SUBSTANTIVE CHANGES**

For most employers, the most significant substantive changes in the final 401(k) regulations are as follows:

- (1) **Hardship Distributions.** Many (but not all) 401(k) plans allow participants to receive a distribution in the event of a “hardship” that creates an “immediate and heavy financial need.”

If a participant requests a hardship distribution, the regulations generally require an employer to review all of the “relevant facts and circumstances” in order to determine whether or not an “immediate and heavy financial need” really exists. In certain situations, however, the regulations permit an employer to assume, without further inquiry, that an “immediate and heavy financial need” does, in fact, exist.

Under the old regulations, an “immediate and heavy financial need” could be deemed to exist if the withdrawal was requested for one or more of the following: (a) payment of medical expenses; (b) purchase of a principal residence; (c) payment of tuition; and (d) payment of an amount that is necessary to avoid eviction or foreclosure.

The new regulations *add* two new “safe harbor hardship events” to this list. The two new events are: (a) payment of funeral expenses; and (b) payment of the cost of repairing damage to the employee’s principal place of residence (if the loss would qualify for a casualty deduction under Code § 165 without regard to the 10% of AGI threshold).

- (2) **Safe Harbor 401(k) Plans - Conditions on Additional Matching Contributions.** Some (but not all) “safe harbor” 401(k) plans provide matching contributions that are in addition to the “safe harbor” 3% employer contribution or in addition to the required “safe harbor” match.

Under the old rules, an employer could require a participant to satisfy a “last day” condition and/or a “1,000 hours” condition as a condition of receiving the additional matching contribution. This was permitted even though these same conditions could not be applied to the “safe harbor” contributions themselves.

Technically, this is still permitted under the new regulations. If, however, an employer does attach conditions to these “additional” matching contributions, the plan will be required to pass the “ADP test.” Since most employers with “safe harbor” plans chose to adopt those plans in order to avoid the need to pass this test, the new regulations effectively mean, as a practical matter, that employers with “safe harbor” plans will not be able to attach conditions to *any* matching contributions they provide.

## II. - “TECHNICAL” CHANGES

The remaining changes that have been made by the final 401(k) regulations are generally “technical” in nature and mostly affect third-party record keepers and other 401(k) professionals. For example, the new regulations change some of the detailed rules that explain how “nondiscrimination testing” should be performed, the various ways in which “testing failures” may be corrected using “qualified non-elective contributions,” and the proper method of calculating “gap period income.”

These changes are important, but employers generally will not notice them because they affect how plans are administered “behind the scene.” So, from this perspective, the final regulations will not have much impact on most employers who have 401(k) plans.

(If you are interested in learning more about these “technical” changes, please feel free to contact our office and we will be happy to provide more information).

## III. - UPDATING PLAN DOCUMENTS

The new regulations will, however, impact every employer with a 401(k) plan for a *different reason*. Under the Internal Revenue Code, when an employer offers a 401(k) plan to its employees, the employer is required to adopt a written plan document that sets forth all of the different rules in the Internal Revenue Code and the Treasury regulations as those rules apply to that particular plan. This is the primary reason that plan documents tend to be as lengthy as they are.

When those rules change, the plan document must generally be updated to reflect the change. The new 401(k) regulations are an example of this. The IRS has determined that the changes made by the new regulations are significant enough that plan documents must be updated to reflect them. Accordingly, *the IRS has announced that all 401(k) plans must be amended to conform to the new regulations.*

#### IV. - DEADLINE FOR UPDATING PLAN DOCUMENTS

The deadline for updating *most* 401(k) plans is the due date of the employer's tax return for the 2006 plan year. There are two exceptions to this general rule, however:

- (1) First, if a 401(k) plan is taking advantage of the hardship provisions of the new regulations, which expand the situations in which a participant may receive a hardship distribution, the plan should be updated by the end of the current plan year.
- (2) Second, if a 401(k) plan is being terminated, the plan must be updated at the time of termination.

Again, *the need to update plan documents is an IRS requirement that applies to all 401(k) plans*. A 401(k) plan must be updated to reflect the details of the final 401(k) regulations, even though the final 401(k) regs may not have any direct impact on the design or day-to-day operation of the plan. If a plan is not updated on a timely basis for these final regulations, it will be subject to disqualification unless and until the failure to update the plan document is corrected through an official IRS correction program.

#### V. - CONCLUDING THOUGHTS

We recognize that having to update 401(k) plans for changes in the law is becoming almost an annual event. Given the pace of recent developments – it seems that at least one new law affecting retirement plans is enacted every year – and the current philosophy of the Employee Plans office at the IRS when it comes to keeping plan documents current, we frankly suspect that annual updates will be with us for some time to come.

There is not much we can do about requirements the IRS imposes. Because of our large client base, we are, however, able to realize certain economies of scale that help to minimize the cost to our clients of adopting these amendments. In the past, the cost of adopting IRS-required amendments has generally been less than \$200. We anticipate that the cost of the IRS-required amendment for the final 401(k) regulations will also be less than \$200.

Because your 401(k) plan was prepared by our firm, we will be sending you an engagement letter in the near future. The engagement letter will outline our fee for updating your plan document, including the preparation of plan document amendments, preparation of an updated Summary Plan Description, and preparation of minutes reflecting the adoption of the amendments.

If you have any questions regarding the final 401(k) regulations or the requirement that the plan document for your 401(k) plan be updated, please feel free to contact either Eric Namee or Steven Smith at (316) 267-2000.