

- Notice 98-1 (1998-1 C.B. 327) provided additional guidance on prior year testing issues.
- Notice 98-52 (1998-2 C.B. 632) and Notice 2000-3 (2000-1 C.B. 413) provided guidance on safe harbor section 401(k) plans.
- Rev. Rul. 2000-8 (2000-1 C.B. 617) addressed the use of automatic enrollment features in section 401(k) plans.
- Notice 2001-56 (2001-2 C.B. 277) and Notice 2002-4 (2002-2 I.R.B. 298) provided initial guidance related to the changes made by EGTRRA.

These items of guidance are incorporated into these proposed regulations with some modifications and the proposed regulations have been reorganized as indicated in the tables of contents at proposed §§ 1.401(k)-0 and 1.401(m)-0. Treasury and the IRS believe that a single restatement of the section 401(k) and section 401(m) rules serves the interests of plan sponsors, third-party administrators, plan participants, and plan beneficiaries.

The process of reviewing and integrating all existing administrative guidance under sections 401(k) and 401(m) has led Treasury and the IRS to reconsider certain rules and to propose certain changes in those rules. To the extent practicable, this preamble identifies the substantive changes and explains the underlying analysis. In many cases, the changes will clarify or simplify existing guidance and will reduce plan administrative burdens.

Treasury and the IRS appreciate the fact that plan sponsors and third-party administrators have developed systems and practices in the application of existing administrative guidance to the design and operation of section 401(k) and section 401(m) plans. In many cases, the details of these systems and practices have been determined through a plan sponsor's or administrator's interpretation of specific terms in existing guidance or, where no guidance has been provided, through a plan sponsor's or administrator's best legal and practical judgment. As a result, these systems and practices may differ from administrator to administrator, from sponsor to sponsor, or from plan to plan.

Treasury and the IRS also recognize that certain of the substantive changes in these proposed regulations will require changes in plan design or plan operation. However, the proposed regulations are not otherwise intended to require significant changes in plan systems and practices that were developed under existing guidance and that conform to the requirements of

sections 401(k) and 401(m). Therefore, Treasury and the IRS specifically request that plan sponsors and third-party administrators comment on points where the proposed regulations might have the unintended effect of requiring a change to plan systems or practices so that Treasury and the IRS can further evaluate whether such a change is in fact appropriate or whether Treasury and the IRS should instead make an adjustment in the final regulations.

Explanation of Provisions

1. Rules Applicable to All Cash or Deferred Arrangements

Section 401(k)(1) provides that a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan will not fail to qualify under section 401(a) merely because it contains a qualified cash or deferred arrangement. Section 1.401(k)-1 would set forth the general definition of a cash or deferred arrangement (CODA), the additional requirements that a CODA must satisfy in order to be a qualified CODA, and the treatment of contributions made under a qualified or nonqualified CODA.

As under the existing final regulations, a CODA is defined as an arrangement under which employees can make a cash or deferred election with respect to contributions to, or accruals or benefits under, a plan intended to satisfy the requirements of section 401(a). A cash or deferred election is any direct or indirect election by an employee (or modification of an earlier election) to have the employer either: (1) Provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available; or (2) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. A cash or deferred election can include a salary reduction agreement, but the specific reference to a salary reduction agreement has been eliminated as unnecessary. In addition, the proposed regulations would incorporate prior guidance on automatic enrollment, and thus would reflect the fact that a CODA can specify that the default that applies in the absence of an affirmative election by an employee can be a contribution to a trust, as described in Rev. Rul. 2000-8.¹

¹ The Department of Labor has advised Treasury and the IRS that, under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), fiduciaries of a plan must ensure that the plan is administered prudently and solely in the interest of plan participants and beneficiaries. While ERISA section 404(c) may serve to relieve certain fiduciaries from liability when participants or

The proposed regulations would continue to provide that the definition of a CODA excludes contributions that are treated as after-tax employee contributions at the time of the contribution and contributions made pursuant to certain one-time irrevocable elections, but would also specify that a CODA does not include an arrangement under which dividends paid to an ESOP are either distributed to a participant or reinvested in employer securities in the ESOP pursuant to an election by the participant or beneficiary under section 404(k)(2)(A)(iii) as added by EGTRRA.

The proposed regulations would also specify that a contribution is made pursuant to a cash or deferred election only if the contribution is made after the election is made. Thus, a contribution made in anticipation of an employee's election is not treated as an elective contribution. Similarly, the regulations would provide that a contribution is made pursuant to a cash or deferred election only if the contribution is made after the employee's performance of services which relate to the compensation that, but for the election, would be paid to the employee. (If the payment of compensation would have preceded the performance of services, a contribution made no earlier than the date the compensation would have been paid, but for the election, is also treated as made pursuant to a cash or deferred election). Accordingly, amounts contributed in anticipation of future performance of services generally would not be treated as elective contributions under section 401(k). These restrictions on the timing of contributions are consistent with the fundamental premise of elective contributions, that these are contributions that are paid to the plan as a result of an employee election not to receive those amounts in cash. Moreover, ensuring that contributions are made after the employee's election furthers plan administrability.

The deductibility of these prefunded elective contributions (as well as prefunded matching contributions) for the taxable year in which the contribution was made was addressed in Notice 2002-48 (2002-29 I.R.B.139). In that notice, the IRS indicated that it was reviewing issues other than the deductibility of prefunded contributions but, pending additional guidance,

beneficiaries exercise control over the assets in their individual accounts, the Department of Labor has taken the position that a participant or beneficiary will not be considered to have exercised control when the participant or beneficiary is merely apprised of investments that will be made on his or her behalf in the absence of instructions to the contrary. See 29 CFR 2550.404c-1 and 57 FR 46924.