TRANSAMERICA CENTER
FOR RETIREMENT STUDIES℠

TCRS 2004-05: A SUMMARY OF REVENUE RULING 2004-13

In Revenue Ruling ("Rev. Rul.") 2004-13, the IRS provided clarification regarding the interactions between the top-heavy rules and safe harbor rules for 401(k) plans. This summary incorporates the four situations cited in the Rev. Rul.

Background

Under Code section 416, a defined contribution plan that is determined to be top-heavy for a plan year must satisfy minimum vesting and contribution requirements. EGTRRA added Code section 416(g)(4)(H) effective for plan years beginning after 12/31/2001. This new Code section provides that the top-heavy requirements will not apply to a 401(k) plan for any plan year if the plan consists solely of a safe harbor feature for that year. Rev. Rul. 2004-13 clarifies the application of this exemption in the following situations involving a nongovernmental 401(k) plan*.

Rev. Rul. 2004-13

Situation 1 *Facts:*
A calendar year safe harbor matching plan also permits profit sharing contributions. Profit sharing contributions are subject to a 5-year, 20% per year vesting schedule. Other than employee deferrals and safe harbor matching, no other contributions or forfeitures were made or allocated for 2004.

Conclusion:
In this Situation 1, the top-heavy rules do not apply for 2004 even though the plan allows profit sharing contributions, because none were made and no forfeitures were allocated for that year.

Situation 2 *Facts:*
Same facts as in Situation 1, except the employer made discretionary profit sharing contributions for 2004 allocated in the same ratio that each participant's compensation bears to the compensation of all participants.

Conclusion:
In this Situation 2, the top-heavy rules apply because the employer made profit sharing contributions and these contributions are not covered by the exemption under Code section 416(g)(4)(H).

Situation 3 *Facts:*
Same facts as in Situation 1, except forfeitures from profit sharing contributions made in a prior year were allocated in 2004. Under the plan, forfeitures are allocated in the same ratio that each participant's compensation bears to the compensation of all participants.

Conclusion:
Under this Situation 3, the top-heavy rules apply because forfeitures were added to participant accounts that year in addition to safe harbor contributions and the forfeiture allocation is not covered by the exemption under Code section 416(g)(4)(H).

Situation 4 *Facts:*
Same facts as in Situation 1, except eligible employees were permitted to make pre-tax contributions immediately, but the match is not provided until they have completed one year of service with the employer.

* Governmental plans are exempt from the top-heavy rules altogether.

Conclusion:
In this Situation 4, the top-heavy rules apply because the plan is not a safe harbor plan by virtue of the one year waiting period for matching contributions. Adding a waiting period results in some non-highly compensated employees missing out on the safe harbor match during the first year. As a result, this plan does not meet the safe harbor rules and is therefore not eligible for the exemption under Code section 416(g)(4)(H).

Plan Design Considerations:

This Rev. Rul. provides necessary and welcome guidance for safe harbor 401(k) plans. The following tips could come in handy when assisting clients in designing their plan.

- Situation 4 reinforces the basic requirement that, in order for a 401(k) matching plan to satisfy the safe harbor rules, the plan as a whole (deferrals & match) must satisfy those rules. Because the matching contributions are not provided to participants who have not completed one year of service, such a plan could effectively provide a rate of matching for highly compensated employees which would be greater than the rate provided to non-highly compensated employees during the one-year waiting period. Such a result would not satisfy the safe harbor rules. Keep in mind that in order for a plan to be safe harbor there can be no conditions imposed on the participant's ability to receive matching contributions except the making of pre-tax contributions.
- A plan that uses forfeitures solely to offset safe harbor contributions during any year would still qualify for the exemption under Code section 416(g)(4)(H) so long as no other employer contributions are being added to participants' accounts that year.
- A 401(k) plan that uses eligibility requirements that are more liberal than age 21 and 1 year of service (e.g. age 18 and 6 months) and provides that split testing (referred to as the "Early Participation Rule" under the Transamerica plans) will be used for a plan year to pass the coverage test, need not provide safe harbor contributions that year to those non-highly compensated employees who have not met age 21 and 1 year of service.

  Split testing is a technique that allows a plan whose eligibility requirements are more liberal than age 21 and 1 year of service to be divided into 2 groups for coverage testing. The first group consists of those eligible employees who satisfied age 21 and 1 year of service and the other group consists of all other employees ("the group of newer and younger employees"). Each group is then tested separately for coverage. If the coverage test is met by each group independently, then no safe harbor contributions would be required for the group of newer and younger employees for that year. Split testing is extremely helpful in keeping the costs of the plan down.

  The Transamerica documents have permitted split testing since 1999, but to use it, a plan sponsor must make the election in the Adoption Agreement.
- The IRS has indicated in a recent seminar that if a plan document specifically states that the plan is a safe harbor plan and the plan sponsor fails to provide the employee notice or the safe harbor contribution, such a failure is a violation of plan terms subject to correction under the Employee Plans Compliance Resolution System ("EPCRS"). EPCRS is an IRS program that allows plan sponsors to correct plan defects.
- This Rev. Rul. did not specifically address 401(k) plans that provide for the 3% non-elective safe harbor.

Emily Urban   Catherine Collinson