STATEMENT OF ROBIN H. VILLANUEVA

ON BEHALF OF

THE AMERICAN BENEFITS COUNCIL

AT THE

INTERNAL REVENUE SERVICE HEARING

ON

PROPOSED 401(k) AND 401(m) REGULATIONS

NOVEMBER 12, 2003

STATEMENT OF ROBIN H. VILLANUEVA
ON BEHALF OF THE AMERICAN BENEFITS COUNCIL
AT THE
INTERNAL REVENUE SERVICE HEARING
ON PROPOSED 401(k) AND 401(m) REGULATIONS
NOVEMBER 12, 2003

Good morning. I am Robin Villanueva, an attorney with the law firm of Davis & Harman, LLP. I am testifying today on behalf of the American Benefits Council, a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

The proposed regulations represent an important step forward in simplifying the regulatory requirements applicable to Code section 401(k) and 401(m) plans and consolidating previously issued guidance.

Because the regulatory and administrative issues surrounding cash or deferred arrangements remain extremely complex, we urge the Service and the Treasury to consider all of the changes and clarifications suggested in the Council's written comments, dated October 22, 2003. Today, I would like to focus on just three of those issues.

ESOP TESTING

Let me begin with ESOP testing. Under the proposed regulations, the portion of a cash or deferred arrangement that is an ESOP and the portion that is not an ESOP would no longer have to perform the plan's ADP and ACP tests on a disaggregated basis. We strongly support this change as a positive step in reducing the complexity of the nondiscrimination requirements applicable to those plans.

First, we ask the Service and Treasury to permit early implementation of the new ESOP testing rule. The preamble to the proposed regulations states that the Service and Treasury anticipate that plan sponsors will be permitted to implement the final regulations for the first plan year beginning after the final regulations are published. For a calendar year plan, this would mean that if the regulations are finalized in 2004, plan sponsors would not be able to implement the regulations, including the new ESOP testing rule, until 2005. Early implementation of the new ESOP testing rule would simplify administration and reduce costs. For this reason, we urge the Service and Treasury to permit plan sponsors to apply this rule to plan years beginning in 2003. Because practices with respect to testing of ESOPs and non-ESOPs have varied widely in the absence of specific guidance, we also urge the Service and Treasury to adopt a

"no inference" policy with respect to testing in the past.
Second, we ask the Service and Treasury to extend the new rule to apply for other testing purposes. The preamble to the proposed regulations states that the mandatory disaggregation rules in the existing regulations would likely cause one disaggregated portion of the plan to fail the ADP/ACP tests because highly compensated employees might be more or less likely to invest in employer securities than are non-highly compensated employees. The proposed regulations do not eliminate the mandatory disaggregation rule for 401(a)(4) and 410(b) testing purposes, and there remains some uncertainty as to how to test these plans on a disaggregated basis when the ESOP portion of the plan is essentially an investment option. For example, if a plan provides for different rates of matching contributions based on length of service, the right to receive each rate of match must be tested under the benefits, rights, and features rules. Under current law, the current and effective availability of each matching rate under the ESOP feature of a 401(k) plan must be tested separately from the availability of each rate under the non-ESOP portion of the plan. Without further clarification, we are concerned that mandatory disaggregation under these circumstances presents the same risk of failure present in the ADP/ACP scenario described in the preamble to the proposed regulations.

In a 401(k) plan under which the employer stock investment option is an ESOP, and a nondiscriminatory group is eligible to invest in employer stock, mandatory disaggregation is not necessary to prevent avoidance of the minimum coverage rules. In order to further simplify testing of plans that include an ESOP feature, we urge the Service and the Treasury to extend the proposed rule to apply to testing under Code sections 401(a)(4) and 410(b).

ALLOCATION OF GAP PERIOD INCOME

Another important issue is the calculation and allocation of gap period income on excess contributions and excess aggregate contributions. Under existing regulations, plans have the option of excluding gap period earnings from corrective distributions. The proposed regulations eliminate the choice of excluding gap period earnings and require plans to distribute such amounts.

The proposed regulations specifically ask for comments on areas where the regulations would complicate plan administration. The requirement of allocating gap period income will create administrative complexity and increased costs that are disproportionate to the amount of the additional distribution. Furthermore, many administrative and recordkeeping systems are currently designed to pick up the contribution data and earnings numbers as of the end of the plan year. The recordkeeper often forwards to the plan administrator or plan sponsor information on the excess contributions and excess aggregate contributions along with the allocated gain or loss. Under the current system, this allows for accurate and timely communication that enables affected participants to prepare their tax returns without having to wait for their corrective distribution to be actually made. The proposed

change to include gap income would require substantial modifications to recordkeeping systems only to capture income or loss for a very short period of time, and participants would not be able to prepare their tax returns until the actual distribution occurred. We believe these problems would be eliminated by reinstating the option to exclude gap period income.

TARGETED QNECS AND QMACS

Next, I would like to address the issue of targeted QNECs and QMACs. The proposed regulations limit the ability to use bottom-up leveling to correct ADP and ACP test failures by providing new formulas for determining whether QNECs and QMACs may be counted towards the relevant tests. This is another area in which the proposed regulation will unduly complicate plan administrative processes. We understand that the Service and Treasury wish to adopt a rule that will promote fairness and prevent high percentage QNECs to a small number of lower paid employees. Nevertheless, the new formulas are very complex, and their implementation will require substantial changes to computer systems and administrative practices. This, of course, will result in a considerable increase in administrative costs. For this reason, we urge the Service and the Treasury to reduce the financial burden on plan sponsors by adopting a safe harbor for targeted QNECs and QMACs that is expressed as a flat dollar amount or a maximum percentage of compensation.

CONCLUSION

Thank you for the opportunity to share with you some of our comments today. Again, the American Benefits Council commends the Service and Treasury for issuing the proposed regulations and urge that they be finalized as quickly as possible. In that process, we encourage the Service and Treasury to make a few additional improvements that will enhance the retirement security of millions of Americans by encouraging plan sponsors to continue to establish and maintain 401(k) and 401(m) plans.