INVESTMENT COMPANY INSTITUTE

October 22, 2003

CC:PA:RU (REG-108639-99)
Room 5226
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Proposed Regulations Regarding Cash or Deferred Arrangements Under Section 401(k) and Matching or Employee Contributions Under Section 401(m)

Dear Sir or Madam:

The Investment Company Institute (the "Institute")[1] appreciates the efforts of Treasury and the Internal Revenue Service to provide comprehensive guidance for retirement plans containing cash or deferred arrangements under Code section 401(k) ("401(k) Plans"). Recently released proposed regulations sections 1.401(k)-0 through 1.401(k)-6 and 1.401(m)-0 through 1.401(m)-5 (the "Proposed Regulations") make significant progress toward simplifying and consolidating the numerous and diverse rules that govern 401(k) Plans. While overall the Proposed Regulations are an excellent and comprehensive restatement of the 401(k) Plan rules, there are some issues raised by the Proposed Regulations where it would be helpful to receive additional clarification.

Calculation of Gap Period Income

The Proposed Regulations provide that income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year and, to the extent the excess contributions are or will be credited with allocable gain or loss for the period after the close of the plan year (gap period), the allocable gain or loss for the gap period.[2] The regulations permit the use of either a safe harbor method or an alternative method for computing gap period income. Both of these methods raise issues for plan participants and administrators.

Under the safe harbor method, income on excess contributions for the gap period is equal to 10% of the income allocable to excess contributions for the plan year, as determined under section 1.401(k)-2(b)(2)(iv)(C) of the Proposed Regulations, multiplied by the number of

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,664 open-end investment companies ("mutual funds"), 601 closed-end investment companies, 106 exchange-traded funds and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.967 trillion, accounting for approximately 95 percent of total industry assets, and 90.2 million individual shareholders. Institute members provide the investment vehicles through which many families save for retirement and also serve as program managers, custodians, trustees, record keepers and service providers for retirement savings vehicles.

[2] Prop. Reg. § 1.401(k)-2(b)(2)(iv)(A).

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calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of a month is treated as made on the last day of the preceding month and a distribution made after the fifteenth day of a month is treated as made on the last day of the month.[3]

Plan administrators will need to consider each year whether to apply the safe harbor because this method can, in certain circumstances, adversely affect participants. For example, suppose that a participant has excess contributions for 2005 that are returned to him or her in a corrective distribution on March 17, 2006. Through December 31 of 2005 the participant had net earnings on the excess contributions, but through March 17, 2006 he or she had net losses on the excess contributions. The safe harbor would require that the plan participant be allocated income attributable to the period from January 1, 2006 through March 31, 2006 by multiplying 10% of the income allocable to excess contributions for 2005 by three months (since a corrective distribution made after the fifteenth day of the month is treated as made on the last day of the month). Because this method can potentially allocate more income to a participant than was actually earned, it is important that the alternative method for calculating gap period income be administratively feasible.

The alternative method for calculating gap period income is administratively challenging because the gap period appears to include the date of distribution, which is problematic for plans using daily valuations. Under the alternative method for calculating gap period income, a plan may determine the allocable gain or loss for the aggregate of the plan year and the gap period by applying the alternative method provided by section 1.401(k)-2(b)(2)(iv)(C) of the Proposed Regulations to this aggregate period.

The alternative method under section 1.401(k)-2(b)(2)(iv)(C) provides that a plan may allocate income to excess contributions for the plan year by multiplying the income for the plan year allocable to the elective contributions and other amounts taken into account under this section (including contributions made for the plan year), by a fraction, the numerator of which is the excess contributions for the employee for the plan year, and the denominator of which is the account balance attributable to elective contributions and other contributions taken into account under this section as of the beginning of the plan year (including any additional amount of such contributions made for the plan year). The alternative method for calculating gap period income would allow the substitution of "income for the plan year and the gap period" in place of "the income for the plan year" and by substituting "contributions taken into account under this section for the plan year and the gap period" in place of "contributions taken account under this section for the plan year" in determining the fraction that is multiplied by that income.[4]

The alternative method of calculating gap period presents administrative challenges for plans that invest in mutual funds, which use daily valuations. Unlike a stock that is actively

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[3] Prop. Reg. § 1.401(k)-2(b)(2)(iv)(D).

[4] Prop. Reg. § 1.401(k)-2(b)(2)(iv)(E).

traded in the secondary market and can have different prices from minute to minute, mutual funds typically are priced once a day as of 4 p.m; these net asset values ("NAVs") typically are disseminated within a few hours and are reported in the next day's papers. Because of the manner in which NAVs are calculated, some amount of earnings (or losses) cannot be included in the redemption price of mutual fund shares. Administrative systems for daily valued plans generally cannot calculate the earnings and process a redemption on the same day because earnings for that day cannot be determined until after the stock market closes. At that point, assets in the plan cannot be sold to make the distribution until the next business day. Under the Proposed Regulations, this locks the daily valued plan into the safe harbor method (calculating gap income as 10% of the plan year income for each month in the gap period), which may not be equitable if the plan's investments performed well during the plan year but incurred a significant loss during the gap period.

The Institute recommends that the Proposed Regulations be amended to clarify that the gap period only includes the date through which the amount of any excess contribution and earnings (or losses) is calculated, which includes a time delay for plans using daily valuations. For example, the gap period could end on the last valuation date of the month preceding the distribution, or any valuation date within a certain number of days of the distribution.

Another way to address this problem would be to retain the rule under the existing regulations that gives daily valued plans the option of excluding gap period earnings. Many administrative and recordkeeping systems are currently designed to pick up the contribution data and earnings numbers as of the plan year end. 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.

The current system allows for more accurate and timely communication that enables affected participants to prepare their tax returns without having to wait for their corrective distribution. The proposed change to include gap income would require substantial modifications to recordkeeping systems and would impose administrative delays on participant communications. The Institute believes reinstating the option to exclude gap period income would eliminate these issues.

Notice Requirements

Section 1.401(k)-1(e)(2)(ii) of the Proposed Regulations, which applies generally to 401(k) Plans, provides that a cash or deferred arrangement satisfies the elections requirements of the regulations only if the arrangement provides an employee with an effective opportunity to make (or change) a cash or deferred election at least once during each plan year. Whether an employee has an effective opportunity to make or change an election is determined based on all the relevant facts and circumstances, including notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.

The current regulations do not include an annual notice requirement for all 401(k) Plans. Section 1.401(k)-1(a)(3)(B)(ii) of the Proposed Regulations incorporates the guidance issued in

Rev. Rul. 98-30 and Rev. Rul. 2000-8, which both provide that a plan may permit automatic enrollment. Unlike Rev. Rul. 98-30 and Rev. Rul. 2000-8, which expressly require that the plan provide participants with notice of the automatic enrollment feature and give them an opportunity to revoke the default election, Section 1.401(k)-1(a)(3)(B)(ii) of the Proposed Regulations does not include a notice requirement.

The inclusion of a notice requirement in the general 401(k) Plan provision (and the absence of a specific notice requirement in the provision regarding automatic enrollment) seems to indicate that a plan must now provide at least annual notice with respect to all 401(k) Plans, not just automatic enrollment plans. If so, it would be helpful if plans were given reasonable flexibility regarding how such notice is provided to participants.

The Institute requests clarification of whether plans, including plans that do not contain an automatic enrollment feature, must provide notice at least annually to participants. If so, the Institute requests that plans be allowed administrative flexibility with respect to the time and manner that such notice must be provided to participants. For example, plans should be permitted to provide notices, including information regarding automatic enrollments, as part of the general notices and information given to eligible participants about participating in the plan. Also, where feasible, plans should be permitted to provide notices electronically. These options will reduce administrative burdens and costs for plans.

Automatic Increase in Deferrals

The Proposed Regulations, in accordance with Rev. Rul. 98-30 and Rev. Rul. 2000-8, permit automatic enrollment. Prop. Treas. Reg. § 1.401(k)-1(a)(3)(i). Neither the language in the revenue rulings nor the relevant provisions of the Proposed Regulations appear to prohibit an employer from contributing increases in compensation or bonuses on an employee's behalf to a trust, provided that the employee has an effective opportunity to elect to receive that amount in cash.[5] These arrangements can increase savings among plan participants who would like to contribute more to their retirement savings plans in the future but initially are unable to make large contributions.

The Institute urges that the Proposed Regulations be amended to clarify that automatic enrollment includes automatic contributions of compensation increases and bonuses received after employment has begun.

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[5] For example, Employee X currently receives annual compensation of $30,000 and defers 3% ($900 per year) of her income under Company Y's 401(k) Plan. The plan includes a provision that 25% of any annual bonus shall be automatically contributed to Company Y's 401(k) Plan on behalf of each employee unless the employee elects to receive this amount in cash. Employee X, who has not elected to receive the full bonus in cash, receives an annual bonus of $1,500 and the plan automatically contributes 25% of her bonus ($375) to the 401(k) Plan on her behalf. The effect of this automatic contribution will be to raise Employee X's annual contribution percentage from 3% of her compensation to over 4% of compensation.

Tax Treatment of Corrective Distributions

There is a discrepancy between the language of the current regulations and the Proposed Regulations relating to the tax treatment of corrective distributions. Section 1.401(k)-1(f)(4)(v) provides that, except as otherwise provided, a corrective distribution of excess contributions (and income) that is made within 2 ½ months after the end of the plan year for which the excess contributions were made is includable in the employee's gross income on the earliest dates any elective contributions by the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash.

Section 1.401(k)-2(b)(2)(vi)(A), which is the corresponding provision of the Proposed Regulations, includes the same language above, except that the word "dates" is now "date." This change, if intended, can change the manner in which some corrective distributions are taxed. For example, suppose that a plan has a fiscal year that runs from December 1, 2005 through November 30, 2006. The plans fails the ADP test and chooses to make corrective distributions to highly compensated participants. Participant A contributed $1000 in each of the first three month's of the plan's fiscal year - December 2005, January 2006 and February 2006, all of which must be returned in a corrective distribution.

The word "dates" in the current regulations would permit $1000 of this corrective distribution to be taxed to Participant A in 2005 and $2,000 of this distribution to be taxed in 2006; since December 2005, January 2006 and February 2006 are the earliest "dates" that each of the $1,000 contributions could have been received, respectively, had the employee elected to receive these amounts in cash. In contrast, the word "date" in the Proposed Regulations could be read to require that Participant A be taxed for the entire $3,000 corrective distribution in 2005, since December 2005 is the earliest "date" that the employee could have elected to receive any part of the corrective distribution in cash.

The Institute urges that the Proposed Regulations continue to use the term "dates," as in the current regulations. The current rule allows plans to report corrective distributions in a manner that more clearly reflects income and is fairer to plan participants.

Amendments to Change ADP and ACP Testing Provisions

The Proposed Regulations provide that a 401(k) Plan can incorporate the ADP and ACP tests by reference. However, the plan must specify any optional provisions, such as the use of current versus prior year testing or the use of safe harbor contributions. It has historically been understood that it is permissible to change the testing method by amending a plan at least through the 2 ½ month period immediately following the close of the plan year. However, the Proposed Regulations do not address the timing of plan amendments to change ADP and ACP testing provisions.

The Institute requests that the Proposed Regulations be amended to provide guidance with respect to amending a plan's testing provisions; specifically, guidance should clarify that a plan has at least until the end of the 2 ½ month period immediately following the close of the

plan year to incorporate such amendments. This rule provides much needed flexibility because in many cases it is unclear that an amendment is needed until after the end of the plan year.

Electronic Submissions

The Preamble to the Proposed Regulations notes that Section 401(k)(12)(D) requires that each eligible employee be provided with a notice of the employee's rights and obligations under the plan. The Proposed Regulations do not address the extent to which the notice requirements can be provided through electronic media. However, Treasury and the Service have invited comments on this issue.

The Institute strongly supports the use of electronic notices and other types of communications with plan participants. Permitting notices and other required communications to be provided to participants, where possible, provides up-to-date information to participants and allows participants to follow-up with plan administrators quickly and efficiently. The use of electronic media also reduces administrative burdens and costs to the plan.

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The Institute commends Treasury and the Internal Revenue Service for their efforts to provide comprehensive guidance for 401(k) Plans. If we can provide you with any additional information regarding these comments or respond to any questions you may have, please do not hesitate to contact me at (202) 326-5835.

Sincerely,

Lisa Robinson