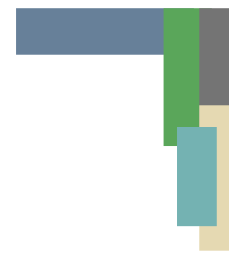

For Immediate Action | **Plan Administration and Operation** | **October 2001***

IRS Publishes Model Amendments for EGTRRA

WHO'S AFFECTED These amendment requirements apply to sponsors of all qualified defined benefit and defined contribution plans, including governmental plans and church plans that do not elect to be covered by ERISA. They do not apply to tax-sheltered annuity plans.

BACKGROUND AND SUMMARY Earlier this year, the IRS announced that plan sponsors will not be allowed to simply operate their plans according to the provisions of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), without making corresponding changes to their plan documents. This is a departure from the IRS's traditional "operational compliance" requirement, which has let plan sponsors operationally comply with new laws for some period of time while their plan documents continued to contain old law provisions.

A plan must have a "good faith" EGTRRA plan amendment in effect for any year that the existing plan document provisions are not consistent with either:

- A required EGTRRA provision; or
- An optional EGTRRA provision that the plan sponsor wishes to use.

Plan sponsors must adopt these "good faith" EGTRRA amendments by the later of:

- The last day of the plan year in which the provision is required to be effective or is optionally put into effect; or
- The plan's GUST** amendment deadline.

The GUST amendment deadline for individually-designed plans is the last day of the plan's 2001 plan year. Employers that intend to adopt prototype or volume submitter documents have until at least December 31, 2002, to restate their plans for GUST.

On August 31, 2001, the IRS published model amendments that plan sponsors may adopt to satisfy the "good faith" EGTRRA amendment requirement.

ACTION AND NEXT STEPS In general, the earliest EGTRRA effective date is January 1, 2002. Therefore, most plan sponsors do not have to actually adopt EGTRRA plan amendments until the last day of the 2002 plan year. However, changes to the defined benefit plan limits apply to limitation years *ending* after December 31, 2001 (i.e., to many limitation years beginning in 2001). In addition, if a plan sponsor wants an optional EGTRRA provision to be effective for the entire 2002 plan year, its recordkeeper may need to be advised of this change *before* the start of the plan

*Republished December 2004 to reflect Prudential Financial's acquisition of CIGNA's retirement business.

** "GUST" refers to: The Uruguay Round Agreements Act, the Uniformed Service Employment and Reemployment Rights Act of 1994, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Internal Revenue Service Restructuring and Reform Act of 1998, and the Community Renewal Tax Relief Act of 2000.

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PRUDENTIAL RETIREMENT

year. As a result, plan sponsors may need to make many EGTRRA design decisions *before the end of 2001*. Even sponsors of plans with non-calendar plan years may need to make these decisions before December 31, 2001, since some provisions are effective January 1, 2002, regardless of a plan's plan year.

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AS WE GO TO PRESS...

"Good Faith" Amendments

In a departure from its usual position on legislative changes, the IRS is not permitting plan sponsors to simply comply in operation with required or optional EGTRRA plan provisions. Plan sponsors must also adopt "good faith" plan amendments documenting these provisions in a timely manner. To help plan sponsors meet this amendment requirement, the IRS has published model amendments for EGTRRA provisions that are effective in 2002. These amendments may need to be adapted to a particular plan's design and terminology. However, as long as those amendments are materially similar to the model amendments, they will satisfy the "good faith" plan amendment requirement.

401(k) Deferral Limit

For employee tax years beginning after December 31, 2001, the 401(k) elective deferral limit is increased to $11,000, with additional increases scheduled for every year through 2006, and cost-of-living increases possible after 2006. This is a *required* EGTRRA amendment for plans that do not correctly incorporate the deferral limit by cross-reference to Internal Revenue Code section 402(g).

Catch-Up Deferral Contributions

Beginning January 1, 2002, plans may permit employees who reach age 50 before the end of the plan year to make additional catch-up deferral contributions. This is an *optional* EGTRRA plan amendment. At the time this model amendment was drafted, the IRS was still working on the specific requirements that will apply to catch-up contributions. Therefore, this amendment is very

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broadly worded. However, the IRS has indicated that if a plan sponsor adopts this amendment, no additional amendment will be required when the IRS publishes the official catch-up contribution guidance.

Vesting of Matching Contributions

For plan years beginning after December 31, 2001, employer matching contributions are subject to faster vesting requirements than other employer contributions. The new minimum vesting options are three-year "cliff" vesting (i.e., 0% vested for less than 3 years of service but 100% vested after three years) and two- to six-year "graded" vesting (i.e., 20% vested after two years of service, increasing in 20% increments each year until the participant is 100% vested after six years of service). More rapid vesting is also permitted.

This is a *required* EGTRRA amendment for plans that currently apply slower vesting schedules to employer matching contributions. However, plan sponsors are given two options for making this change. The new vesting schedule may be applied to all matching contributions made under the plan, including those made for plan years beginning before January 1, 2002. Alternatively, the new schedule may be applied to just those matching contributions made for the 2002 and later plan years.

This vesting requirement is only required to apply to participants who have at least one hour of service under the plan in plan years beginning after December 31, 2001. It does not have to apply to former employees who continue to maintain account balances under the plan, although a plan sponsor could certainly apply it to those participants as well.

In addition, while these new rules only apply to employer matching contributions to defined contribution plans, they may have an indirect impact on vesting schedules applied to other types of employer contributions or benefits. For example, some plan sponsors apply the same vesting schedules to all types of employer contributions made to their 401(k) plans, for administrative ease. Similarly, other plan sponsors apply the same vesting schedules to all of their defined contribution and defined benefit plans. In these situations, plan sponsors may wish to amend those other vesting schedules as well.

Annual Additions Limit

For *limitation years* beginning after December 31, 2001, the limit on a participant's defined contribution plan annual additions is the lesser of $40,000 (as adjusted for cost-of living increases) or 100% of the participant's compensation. This is a *required* EGTRRA amendment for plans that do not incorporate these limits by cross-reference to Internal Revenue Code section 415(c).

Defined Benefit Plan Limits

EGTRRA changes to defined benefit plan limits affect different types of plans in different ways.

For limitation years *ending* after December 31, 2001, the limit on a participant's *governmental plan* benefit is $160,000 (as adjusted for cost-of-living increases). This limit is reduced when benefit payments begin before the participant reaches age 62, and it is increased when benefit payments begin after age 65. The special $75,000 benefit floor for participants who are at least age 55 is

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eliminated.
For limitation years *ending* after December 31, 2001, the limit on a participant's benefit provided under a *single employer non-governmental plan* is the lesser of $160,000 (as adjusted for cost-of-living increases) or 100% of the participant's average compensation for the highest three years. This limit is reduced when benefit payments begin before the participant reaches age 62, and it is increased when benefit payments begin after age 65.

The new limit of the lesser of $160,000 (as adjusted for cost-of living increases) or 100% of the participant's average compensation for the highest three years, with pre-age reductions and post-age 65 increases, also applies to benefits provided by *multiemployer plans* for limitation years *ending* after December 31, 2001. In addition, for limitation years *beginning* after December 31, 2001, the multiemployer plan benefit limit is simply $160,000 (as adjusted for cost-of-living increases), with pre-age 62 reductions and post-age 65 increases. As a result, multiemployer plans with non-calendar limitation years will have to deal with two benefit limit changes over the next two years.

> *For example: Multiemployer Plan A has a limitation year that runs from July 1 through June 30. For the limitation year beginning July 1, 2001, and ending June 30, 2002, the benefit limit is the lesser of $160,000 (as adjusted for cost-of-living increases) or 100% of average compensation. For the limitation year beginning July 1, 2002, and ending June 30, 2003, the benefit limit is just $160,000 (as adjusted for cost-of-living increases).*

These are *optional* EGTRRA amendments for plans that do not incorporate these limits by cross-reference to Internal Revenue Code section 415(b). In addition, plan sponsors may choose to provide the resulting benefit increases either to all current and former participants whose benefits had been limited under the pre-EGTRRA rules or to just participants who have at least one hour of service under the plan on or after the first day of the first limitation year ending after December 31, 2001. Before making any amendments to these plan provisions, plan sponsors should consult the plan's enrolled actuary regarding potential funding impacts.

Annual Compensation Limit

For plan years beginning after December 31, 2001, a plan may take into account up to $200,000 (as adjusted for cost-of-living increases) of a participant's annual compensation for purposes of determining benefits and contributions and performing nondiscrimination tests. This is a *required* EGTRRA amendment for plans that do not impose a lower limit on the amount of compensation taken into account for these purposes.

In addition, a plan (such as a defined benefit or target benefit plan) that uses average compensation for determining accruals or allocations may apply the $200,000 limit to compensation for periods before January 1, 2002, which are used in determining accruals or allocations for the 2002 and later plan years. This is an *optional* EGTRRA plan amendment. Future cost-of-living increases to the $200,000 limit cannot be applied to prior years' compensation amounts. Here too, before making any amendments to these plan provisions, plan sponsors should consult the plan's enrolled actuary regarding potential funding impacts.

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Rollover Rules

EGTRRA makes many changes to the rollover rules. Some of these changes require plan amendments, while other amendments are optional.

Beginning January 1, 2002:

- Plans that permit hardship withdrawals of contributions other than 401(k) deferrals *must be amended* to provide that these hardship withdrawals are no longer eligible for rollover. (Hardship withdrawals of 401(k) deferrals have not been eligible for rollover since January 1, 1999.)
- Plans that accept post-tax employee contributions (including contributory defined benefit plans) *must be amended* to provide that these contributions are now eligible for rollover.
- All plans *must be amended* to provide that eligible rollover distributions may be rolled over to another qualified plan, a tax-sheltered annuity plan, a governmental section 457 plan, or an Individual Retirement Account (IRA) other than a SIMPLE IRA, Roth IRA or Education IRA.

All of these changes apply to distributions made after December 31, 2001, regardless of the plan's plan year.

Also, beginning January 1, 2002, plans may choose to accept types of rollover contributions that are not currently accepted. While plans do not have to accept rollover contributions at all, plan sponsors that want to limit the types of rollover contributions the plan will accept *must make the appropriate amendments* with respect to direct and indirect rollovers:

- From qualified plans;
- From tax-sheltered annuity plans;
- From governmental section 457 plans;
- From traditional IRAs other than "conduit IRAs;" and/or
- Of employee post-tax contributions.

Plan sponsors may make these changes effective at any time after December 31, 2001.

Involuntary Cash-Out Rules

Effective any time after December 31, 2001, a defined contribution plan sponsor may choose to exclude rollover contributions in determining whether the value of a participant's vested account balance exceeds the plan's involuntary cash-out threshold. The plan sponsor may choose to apply this exclusion to participants who left employment before January 1, 2002. These are *optional* EGTRRA plan amendments.

401(k) Hardship Withdrawal Suspension Rules

EGTRRA lowered from 12 months to six months the minimum elective deferral suspension period that applies when a participant takes a hardship withdrawal of deferral contributions under the safe harbor hardship withdrawal rules. For most 401(k) plans, this EGTRRA amendment is *optional*. However, an amendment is *required* for ADP/ACP safe harbor plans.

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Sponsors of most 401(k) plans that apply the safe harbor hardship withdrawal rules may choose among the following suspension options:

- They may continue to apply the pre-EGTRRA suspension period to hardship withdrawals taken after December 31, 2001. No EGTRRA plan amendment would be needed in this situation.
- They may apply the pre-EGTRRA suspension period to hardship withdrawal taken before January 1, 2002, and the shorter EGTRRA suspension period to hardship withdrawals taken after December 31, 2001. An EGTRRA plan amendment would be needed.
- They may apply the shorter EGTRRA suspension period to hardship withdrawals taken in 2001, so that a participant's suspension period would end six months after the date of withdrawal, or on January 1, 2002, if later. Hardship withdrawals taken in 2002 would be subject to the new rules. An EGTRRA plan amendment would be needed.

Sponsors of ADP/ACP safe harbor plans have only two options, both of which require plan amendments:

- Apply the pre-EGTRRA suspension period to hardship withdrawals taken before January 1, 2002, and the shorter EGTRRA suspension period to hardship withdrawals taken after December 31, 2001.
- Apply the shorter EGTRRA suspension period to hardship withdrawals taken in 2001, so that a participant's suspension period would end six months after the date of withdrawal, or on January 1, 2002, if later. Hardship withdrawals taken in 2002 would be subject to the new rules.

Top-Heavy Rules

EGTRRA made many changes to the top-heavy plan rules. Effective for plan years beginning after December 31, 2001, ADP/ACP safe harbor plans (i.e., 401(k) plans that meet special design requirements so they do not have to perform the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests) are not subject to the top-heavy rules. This is a *required* EGTRRA amendment for these plans.

When determining a plan's top-heavy status for the 2002 and later plan years, the new "key employee" definition applies. For example, if the plan's 2002 plan year begins on January 1, 2002, key employees include only those employees who were: 5% owners on any day in the 2001 plan year; or 1% owners on any day in the 2001 plan year earning more than $150,000 for that year; or officers on any day in the 2001 plan year, earning more than $130,000 for that year.

In addition, for 2002 and later plan years, account balances and accrued benefits must be increased by the amount of retirement, termination, death or disability distributions made during *just* the determination year (e.g., 2001, when determining if a plan is top-heavy for 2002). However, in-service distributions made during the determination year *and* the four previous plan years must be counted. Also, account balances and accrued benefits belonging to former employees who performed no services for the employer during the determination year are no longer included in the top-heavy determination.

These revisions to the key employee definition and account and benefit determination rules are *required* EGTRRA amendments for all plans that are subject to the top-heavy rules.

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Effective for plan years beginning after December 31, 2001, employer matching contributions made to non-key employees are taken into account in determining whether the minimum contribution or benefit requirement has been met. This is a *required* EGTRRA amendment for defined contribution plans that accept, or are aggregated for top-heavy testing purposes with plans that accept, employer matching contributions.

Effective for plan years beginning after December 31, 2001, the defined benefit minimum benefit calculation does not include service with the employer when the plan was frozen and did not benefit any key employees or non-key employees. This is a *required* EGTRRA amendment for defined benefit plans that are subject to the top-heavy rules.

Multiple Use Test

For plan years beginning after December 31, 2001, the multiple use test no longer applies to 401(k) plans that also accept employee post-tax contributions or employer matching contributions. This is a *required* EGTRRA plan amendment for these plans.

Plan Loan Availability

Previously, owner-employees (partners in partnerships, including some LLCs and LLPs, and sole proprietors) and S corporation shareholder-employees were not covered by the general prohibited transaction exemption that permitted other employees to take plan loans. Owner-employees and shareholder-employees could take plan loans only if they first obtained an individual prohibited transaction exemption from the Department of Labor (DOL). Many plans simply prohibited these employees from taking loans altogether. Beginning January 1, 2002, these employees will be covered by the general prohibited transaction exemption and plans may no longer prohibit these employees from taking loans. This is a *required* EGTRRA amendment for plans that contain either the prohibition on loans to these employees or the requirement that they obtain individual prohibited transaction exemptions.

Elimination of the Same Desk Rule

Effective January 1, 2002, EGTRRA eliminates the "same desk rule," which had prevented many 401(k) plans from making distributions to former employees who continued working at the same job but for a different employer as the result of a merger, liquidation or similar corporate transaction. Section 401(k) plans may permit distributions to be made after December 31, 2001, due to a severance of employment. These distributions may be made regardless of when the severance occurred or for severances occurring after a specified date. This is an *optional* EGTRRA plan amendment.

Plan Sponsors Must Make Decisions

While the earliest amendment deadline for these EGTRRA amendments is the last day of the 2002 plan year, plan sponsors must make some of the design decisions *before* the start of the 2002 plan year. For example, affected plan sponsors must decide, before the start of the 2002 plan year, which new vesting schedule will be applied to matching contributions and to which group of participants that new schedule will apply. Otherwise, the processing of distributions to employees

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who terminate employment in early 2002 may be delayed. If the payments are not delayed, they may be underpaid and additional distributions may be needed later in the year.

Another decision that must be made before January 1, 2002 (regardless of the plan's plan year) is how to apply the new 401(k) hardship withdrawal suspension rules. If these rules will be applied to withdrawals taken in 2001, the employer's payroll system will need to resume taking deferral contributions on January 1, 2002, for many employees who would not have been eligible to make deferrals under the old rules.

Some defined benefit plan sponsors may also have to amend their plans before the first day of the 2002 plan year in order to apply the new top-heavy plan rules in 2002 without impermissibly reducing 2002 benefit accruals.

As We Go to Press…

As we went to press with this issue of the *Pension Analyst*, the IRS published additional EGTRRA guidance.

This includes:

- Guidance regarding the increased limits on annual additions to defined contribution plans and the increased defined benefit plan benefit limits. Specifically, the IRS addresses various effective date questions, as well as the application of the EGTRRA "sunset provision" to defined benefit plan minimum funding requirements. Under the "sunset provision," the defined benefit plan limits revert to the pre-EGTRRA limits after December 31, 2010, unless Congress takes steps to extend the EGTRRA limits. (IRS Revenue Ruling 2001-51.)

- Proposed rules regarding catch-up deferral contributions. These rules, which plan sponsors may follow until the IRS publishes final rules, address:
  - An individual's eligibility to make catch-up contributions;
  - The manner in which catch-up contributions are determined;
  - The treatment of catch-up contributions for purposes of various testing requirements;
  - The universal availability rule; and
  - The determination of catch-up amounts for individuals who participate in more than one plan during a single plan year or calendar year.

  (October 23, 2001, proposed regulations.)

  A future issue of the *Pension Analyst* will discuss this catch-up contribution guidance in more detail.

- Instructions for reporting catch-up contributions made in 2002 on participants' 2002 Forms W-2 (which employers will issue to these participants in early 2003). (IRS Announcement 2001-83.)

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- A description of the low income saver's credit for individuals who make contributions to retirement plans or Individual Retirement Accounts (IRAs). IRS Announcement 2001-106 also includes a sample notice that employers may distribute to their employees to tell them about this credit.

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