

Publications

IRS Releases Sample EGTRRA Amendments and Key Effective Date Guidance

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SERVICES

True to the commitment made in Notice 2001-42, on August 31, the IRS released sample EGTRRA amendments (Notice 2001-57) that qualified plan sponsors may use to adopt EGTRRA changes to their plans. Notice 2001-56, released the same day, provides helpful guidance on effective date issues related to the \$200,000 compensation limit, top-heavy changes and the reduction to 6 months in the suspension period for 401(k) hardship withdrawals. The Notices are available on IRS's website (www.irs.gov). Both releases are reviewed below.

I. Effective Date Guidance

A. Increase in Compensation Limit

EGTRRA increases the annual compensation limit (sec. 401(a)(17)) from \$170,000 to \$200,000 for "years beginning after December 31, 2001."

Most defined benefit plans base benefits on annual compensation for a period of years so a critical question is whether plans may apply the \$200,000 limit to pre-2002 plan years — resulting in a potentially significant increase in accrued benefits for 2002. Notice 2001-56 provides the following guidance on this issue.

* Plans may provide for application of the \$200,000 limit to prior years (e.g., if the plan has a high-3 or high-5 formula). An example clearly illustrates the impact on benefits of a participant with compensation over \$200,000 for the relevant period. Notice 2001-57 contains sample amendments.

* Plans are not required to apply the higher limit retroactively.

* Plans may adopt any cap above \$170,000 and below \$200,000 for future years.

The Notice does not address the possibility that plans that incorporate the section 401(a)(17) limit by reference, and that do not wish to apply the \$200,000 cap to pre-2002 years, may need to amend before the 2002 plan year begins to avoid potential cutbacks. However, such early amendments should be made to avoid potential

problems. (Notice 2001-42 noted that EGTRRA did not provide anti-cutback rule relief.)

B. Top-Heavy Changes

EGTRRA makes a handful of changes in the top-heavy area, including several relating to the determination of “key employees” and whether a plan is top-heavy for “years beginning after December 31, 2001.” For example, the compensation threshold for officers is increased from \$70,000 to \$130,000 and the 5-year look back is shortened to 1 year for most purposes.

Notice 2001-56 generally provides that the EGTRRA changes generally apply for determining whether a plan is top-heavy for the 2002 plan year. For example, a calendar year plan with a December 31, 2001 determination date may determine its key employees for 2001 based on the EGTRRA changes for purposes of its 2002 plan year. Notice 2001-57 includes sample top-heavy amendments, which will be required for most plans (except “safe harbor” section 401(k)/(m) plans).

C. 6-Month Suspension Period

Many section 401(k) plans have adopted an IRS regulatory safe harbor (Treas. Reg. _ 1.401(k)-1(d)(2)(iv)(B)) for making hardship distributions of elective deferrals. One requirement of the safe harbor is that the employee is prohibited from making elective deferrals and employee contributions under the plan and all other plans of the employer (including nonqualified plans, but not welfare plans) for at least 12 months after receipt of the hardship distribution. EGTRRA directed Treasury to shorten the regulatory suspension period to 6 months for “years beginning after December 31, 2001.” Notice 2001-56 provides the following guidance.

* The revised regulations will apply to calendar years beginning after 2001, not only to distributions made after 2001. Thus, a plan may apply the 6-month period to hardship distributions made in 2001 if it wishes to do so. For example, participants who received hardship distributions before July 1, 2001 could resume elective deferrals January 1, 2002. (Unfortunately, the Notice does not address how the elective deferral limit, under the third-prong of this safe harbor, applies to participants who benefit from the new shorter suspension period.)

* Plans are not required to apply the 6-month rule to pre-2002 distributions and may retain the 12-month rule for post-2001 distributions.

* Safe harbor 401(k)/(m) plans must reduce the suspension period to 6 months, at least for post-2001 distributions. We note that section 403(b) plans that follow the 401(k) rules for making hardship distributions under section 403(b)(11) should be able to apply this guidance as well.

II. Sample Amendments

Notice 2001-57 provides basic sample amendments for all of the EGTRRA provisions that normally would be reflected in a qualified plan document (e.g., provisions for matters such as deduction limit changes, including the ESOP dividend deduction, are not reflected) and that take effect in 2002 (e.g., there are no “deemed IRA” (2003) or Roth 401(k) (2006) provisions). With the exception of the direct rollover, top-heavy, and certain section 415 amendments, the amendments are optional. Notice 2001-57 reviews in some detail the principles announced in Notice 2001-42 for when EGTRRA amendments may or must be adopted, and includes some comments intended to assist in making such determinations.

Although clearly focused on qualified plans, the IRS notes that some of the amendments may be appropriate for 403(b) plans and that future guidance will address 457 plans.

For the most part, the sample amendments track the statutory provisions and “should not be viewed as interpretive guidance.” (A good example is the “barebones” provision for “catch-up” contributions, where the Notice indicates guidance will be issued “in the near future.”) The Notice also emphasizes that changes to these sample amendments may be required after guidance is issued.

Although generally not interpretive in nature, the sample amendments do provide substantive indications on some issues, such as the following:

* “Same Desk” Relief — The sample provides that distributions may be made after 2001 for “severances from employment” either after 2001 or regardless of when severance occurred.

* Rollovers — The sample makes it clear that only qualified defined contribution plans (not defined benefit plans) have the option to accept rollovers of after-tax contributions from another qualified plan. Another sample amendment in the Notice confirms that plans

that ignore rollovers (as EGTRRA permits) for purposes of determining whether a participant's account exceeds \$5,000 will cash out the entire amount (rollover plus plan contribution amounts) on termination of employment.

* Vesting on Matching Contributions — The sample amendment is designed so that plan sponsors may apply the new more rapid vesting rule only to matching contributions made for 2002 and later years, or to all matching contributions.

* Increased Section 415 Dollar Limits for DB Plans — Although the Notice indicates that guidance will be issued “in the near future,” the sample amendments provide options for applying the increased limits to all current and former participants whose accrued benefits have been limited and have not been fully paid out, as was the case with the repeal of section 415(e). (Presumably, the future guidance will closely track the principles of Notice 99-44 in this area.)

III. Observations

The IRS is off to a good start in helping plan sponsors and administrators implement basic EGTRRA changes. These two Notices provide enough information to start evaluating whether a plan sponsor wants to have its qualified DB plan pick up liabilities associated with increases in the compensation and benefit limits. DC plan sponsors and administrators presumably will want to wait for the guidance on the new catch-up provision before they put together their package of 2002 EGTRRA amendments. We expect that more helpful guidance will be issued in several other areas in the few months that remain before the EGTRRA provisions take effect.