

Highlights of EGTRRA Provisions Affecting Qualified Retirement Plans

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Practice Area: Compensation and Benefits/ERISA

Many of the provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") will have a significant impact on qualified retirement plans. The following is a brief summary of the major changes.

- Compensation Limit. The limit under Code section 401(a)(17) on compensation that may be used for purposes of a qualified plan will increase from \$170,000 in 2001 to \$200,000 in 2002. The limit will be adjusted periodically in \$5,000 increments in future years based upon increases in the cost of living.
- Contribution Limit. The annual individual employee contribution limit under Code section 415 for a defined contribution plan will increase from the lesser of \$35,000 or 25 percent of compensation in 2001 to the lesser of \$40,000 or 100 percent of compensation in 2002. After 2002, the \$40,000 dollar limit will be adjusted periodically in \$1,000 increments based upon increases in the cost of living.
- Benefit Limit. The annual individual employee limit under Code section 415 for benefits under a defined benefit plan that begin between age 62 and age 65 will increase from \$140,000 per year in 2001 to \$160,000 per year, effective January 1, 2002. After 2002, the \$160,000 limit will be adjusted periodically in \$5,000 increments based upon increases in the cost of living.
- Elective Deferral Limit. The limit under Code section 402(g) on elective deferrals to 401(k) or 403(b) plans will increase from \$10,500 in 2001 to \$11,000 in 2002, and will be further increased \$1,000 per year until the limit is \$15,000 in 2006. The limit will be adjusted periodically in \$500 increments based upon increases in the cost of living.
- "Catch-Up" Elective Deferrals. Beginning in 2002, a 401(k) or 403(b) plan may (but need not) permit participants who are over age 50 to make additional elective deferrals in excess of otherwise applicable limits. The amount of catch-up deferrals permitted in 2002 will be \$1,000. The amount will increase to \$2,000 in 2003, \$3,000 in 2004, \$4,000 in 2005 and \$5,000 in 2006. Thereafter, the amount will be periodically adjusted in \$500 increments based upon cost of living increases. The catch-up contributions will not be taken into account, for example, in applying the Code section 402(g) and 415 limits mentioned above, nor the "actual deferral percentage" ("ADP") limit that applies to 401(k) plans.
- Hardship Distributions. A 401(k) plan may permit participants to take withdrawals from the plan if the participants incur a hardship. Under applicable law, a 401(k) plan may deem that a withdrawal is made on account of a hardship if certain conditions are met. Currently, one condition for a deemed hardship is that the plan must prohibit a participant who takes a hardship withdrawal from making elective deferrals to the plan for 12 months. Beginning in 2002, a 401(k) plan may reduce this 12-month period to six months.
- Top-Heavy Rules. The "top heavy" rules require that a qualified plan meet certain minimum benefit and vesting rules if the benefits for key employees under the plan exceed 60 percent of the accrued benefits in a defined benefit plan or 60 percent of the aggregate account balances in a defined contribution plan. Beginning in 2002, the definition of "key employee" will be simplified and the top-heavy rules will be modified.
- Lump Sum Distributions of Small Amounts. A qualified plan may require an immediate lump sum distribution, without the participant's consent, to a participant who terminates employment with an account balance of \$5,000 or less. Beginning in 2002, a plan may disregard amounts rolled over to the plan from another qualified plan, and the earnings thereon, in determining whether a participant's account balance exceeds \$5,000 for purposes of this rule.
- Rollover Rules. **The following changes will be made to the rollover rules:**
- Rollovers of After-Tax Contributions Allowed. Beginning in 2002, a participant may rollover a distribution of after-tax contributions that the participant made to a qualified plan. The rollover must be to an IRA or a qualified defined contribution plan that accepts such rollovers. The rollover may not be to a section 403(b) tax sheltered annuity plan or a section 457 plan.
- Rollovers from IRAs. Beginning in 2002, qualified plans and 403(b) plans will be able to accept rollovers from IRAs.
- Expansion of Rollover Rules. Currently, surviving spouses may only roll over eligible distributions from a qualified plan to an IRA. Also under current law, employees may roll over eligible distributions only to an IRA or another qualified plan or 403(a) annuity that accepts such rollovers. Beginning in 2002, employees and surviving spouses will be permitted to roll eligible distributions to an IRA or another qualified plan, 403(a) annuity, 403(b) plan or government 457(b) plan that accepts such rollovers.

accepts such rollover.

- **Automatic Rollovers.** Qualified plans will be required to provide for automatic rollovers of mandatory distributions that are more than \$1,000 but not more than \$5,000. This requirement will not be effective until after the Department of Labor issues final regulations providing safe harbors under which the designation of a financial institution and the investment of funds for the automatic rollovers will be deemed to satisfy the fiduciary requirements of ERISA.

(Note: Code section 402(f) requires that the plan administrator of a qualified plan or tax deferred annuity provide a written explanation of the rollover rules to individuals who receive an eligible rollover distribution. EGTRRA expands the requirements under Code section 402(f) regarding written notices that must be provided to recipients of eligible rollover distributions. **Beginning in 2002, qualified plans must make a reasonable, good faith effort to comply with the expanded Code section 402(f) notice requirements.**)

- **Deemed IRAs.** Beginning in 2003, a qualified plan may establish "deemed IRA" accounts. These will be separate accounts that meet IRA requirements and accept voluntary employee contributions.
- **Roth 401(k) Plans.** Beginning in 2006, a 401(k) or 403(b) plan may permit participants to make after-tax contributions to the plan. The employee will be able to exclude from gross income later related distributions from the plan if certain requirements are met.

EGTRRA Remedial Amendment Period

The period for amending qualified plans to comply with changes in the law is called the "remedial amendment period." The remedial amendment period for EGTRRA is somewhat confusing. The EGTRRA remedial amendment period will end no sooner than the last day of the plan year that begins in 2005. However, to be eligible for the remedial amendment period, a plan must have a "good faith" EGTRRA plan amendment in effect by the later of:

- The end of the plan year that the EGTRRA plan amendment is effective; or
- The end of the GUST remedial amendment period for the plan.

For example, if a plan sponsor wants to take advantage of the increase in contribution or benefits limits in 2002, the plan sponsor must adopt good faith EGTRRA amendments by the last day of the 2002 plan year.

The IRS has issued model EGTRRA amendments that may be used as "good faith" EGTRRA amendments.

If an EGTRRA amendment reduces future accruals, the amendment may not be retroactive. For example, if a plan is top heavy, the plan sponsor might want to amend the top-heavy provisions before nonkey employees accrue a minimum benefit for 2002 under the old top-heavy rules. Non-key employees must complete 1,000 hours of service to be eligible for a minimum accrual under a top-heavy plan. The date that non-key employees will be deemed to accrue 1,000 hours of service for 2002 will be May 31, 2002. **Consequently, in most cases the sponsor of a top-heavy plan will want to amend the plan's top-heavy provision no later than May 31, 2002.**

Other EGTRRA Provisions

Other provisions in EGTRRA may affect a plan's operations, but will not require plan amendments. For example:

- Increase in Deduction Limit. There will be three important changes to the limit on the deduction of contributions to defined contribution plans beginning in 2002. First, the deduction limit for contributions to profit sharing, stock bonus and 401(k) plans will increase from 15 percent of compensation to 25 percent of compensation. Second, "compensation" will include salary reductions under a 401(k) plan or section 125 cafeteria plan. Third, elective deferrals to a 401(k) plan will not be subject to the deduction limit.
- "Same Desk" Rule Eliminated. Generally, an employee may not receive a distribution of his or her salary deferrals under a 401(k) or 403(b) plan until the employee attains age 59-1/2, "separates from service," becomes disabled or dies. Under the "same desk rule" promulgated by the IRS in revenue rulings, an employee who terminates employment due to a sale or reorganization of the employer does not experience a "separation from service" if the employee continues to work for the successor employer. Beginning in 2002, EGTRRA repeals the same desk rule for purposes of the restrictions on distributions from 401(k) and 403(b) plans.
- Coverage Tests. EGTRRA directs the IRS to amend the regulations regarding coverage requirements under Code section 410(b) for 401(k) plans maintained by tax-exempt entities. The regulations are to provide that a tax-exempt entity may disregard employees who are covered by a 403(b) plan when applying the coverage tests to the tax-exempt entity's 401(k) plan provided certain conditions are met.

Sunset

The EGTRRA changes summarized above will not apply to years after December 31, 2010.

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