



## NEW LEGISLATION FAVORABLY IMPACTS 401(k) AND OTHER QUALIFIED RETIREMENT PLANS

### THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

The recently passed tax bill known as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), made significant modifications to the rules affecting qualified plans. These retirement law amendments are particularly noteworthy because most take effect in 2002.

#### Increased Contribution and Benefit Limits

- **401(k) contribution limit** will be increased to \$15,000 over the next five years. The limit will increase to \$11,000 for calendar year 2002, with \$1,000 increases in each of the next four years.
- **Annual Additions Limit for Defined Contribution Plans** will be increased to the lesser of \$40,000 or 100% of compensation, effective in 2002. Currently, the limit is the lesser of \$35,000 or 25% of compensation.
- **Annual Additions Limit for Defined Benefit Plans** will be increased to \$160,000 for limitation

years ENDING after December 31, 2001, and the dollar limit need only be actuarially reduced for benefits commencing before age 62 (rather than the Social Security retirement age).

- **Eligible Compensation limit** will be increased from \$170,000 to \$200,000 effective in 2002.
- **“Catch-up” Contributions:** Individuals age 50 and older will be permitted to make additional deferral contributions (above the normal limits) to 401(k) plans as follows:

YEAR	401(k) CATCH-UP
2002	\$1,000
2003	\$2,000
2004	\$3,000
2005	\$4,000
2006 and thereafter	\$5,000

#### Increased Deduction Limits effective in 2002

- **Profit sharing plans (including 401(k) plans)** will have an increased deduction limit for

employer contributions equal to 25% of compensation. (The current limit is 15%.)

- **Employee elective deferrals** to a 401(k) plan will be separately deductible and will not “eat away” at the 25% limit for other employer contributions.
- **Compensation** for deduction calculation purposes will no longer be reduced for employee elective deferrals to a 401(k) plan or section 125 cafeteria plan.

#### Miscellaneous changes generally effective in 2002

- **Matching contributions** will be required to vest under a faster vesting schedule (i.e., either 3-year cliff or 6-year graded).
- **Plan loans** become available to participants who are owners of an unincorporated employer (e.g. sole proprietorship, partnership, LLC) or “S” corporation.
- **Safe harbor 401(k) plans** which consist solely of safe harbor matching contributions or safe harbor nonelective contributions will be deemed to be a non-top heavy plan.
- **Matching contributions** may be

used to satisfy the top heavy minimum contribution obligation for non-key employees.

- **“Frozen” defined benefit plans** will no longer be required to provide minimum accruals for non-key employees.

- **Rollovers** among the various types of retirement arrangements (i.e., qualified retirement plans, section 403(b) annuities, and governmental section 457 plans) will now be permitted, subject, in some cases, to new special rules.

- **After-tax employee contributions** will also be permitted to be included in a rollover.

This is but a brief summary of the many new pension provisions included in EGTRRA.

As always, the definitive application of these new provisions is contingent upon the issuance of regulations by the IRS. Also, all of the amendments made by the new law expire for

taxable years, limitation years, and plan years that begin after December 31, 2010. If Congress does not extend the provisions before this “sunset” date, the law will revert back to the rules as they exist today!

**IRS REPORTS ON 401(K) AUDITS**

Every year the IRS issues a list of audit priorities and every year 401(k) plans are at or near the top of the list.

The IRS has reported the results of its most recent 401(k) audit program. (See

[www.irs.gov/bus\\_info/ep/401k.html](http://www.irs.gov/bus_info/ep/401k.html).)

The primary purpose of the program is to identify areas in which 401(k) plans failed to comply with the Internal Revenue Code (“violations”) and to obtain information on the sizes of the plans containing these violations.

From 1995 to 1997 the IRS examined and compiled data on 472 401(k)

plans. The selected plans were divided into four groups based on the number of participants. Small plans were those with up to 16 participants, medium plans had 17 to 53 participants, large plans had 54 to 60,000 participants, and super-large plans had over 60,000 participants. The table at the end of this article shows the number of plans, by size, containing one or more violations. Overall, 44% of the audited plans had violations. The IRS hopes that the information obtained from this program will encourage plan sponsors, employers, and others to take a more active role in maintaining the tax-qualified status of their own 401(k) plans by identifying where violations are more likely to occur. Even though there are now numerous programs available to correct most plan qualification violations, prevention is still the best cure!

Plan Size Category	Total Number of Plans	Plans with No Violations	Plans with Violations	Percent of Plans with Violations
All Plans	472	264	208	44%
Small Plans (S)	139	82	57	41%
Medium Plans (M)	162	86	76	47%
Large Plan (L) and Super-Large Plans (SL)	171	96	75	44%

**NEW COMPARABILITY REGULATIONS ISSUED**

The Department of Treasury (“Treasury”) and the IRS have issued proposed regulations prescribing certain conditions under which new comparability plans may continue to demonstrate compliance with the nondiscrimination rules using current testing methods. As previously reported, these plans have come under fire from Treasury, which has argued that new comparability plans disproportionately benefit highly

compensated employees (“HCEs”) in an inappropriate manner. A new comparability plan (also known as a cross-tested plan) is one in which different contribution allocation formulas apply to different classifications of employees (e.g. HCEs and non-highly compensated employees (“NHCE”s)). The Treasury’s primary motivation in proposing these rules is to address the fact that NHCEs are often not able to “grow into” the higher allocation rates available under a new comparability plan. Higher

allocation rates are normally provided only to owners and HCEs.

Several plan design alternatives are offered by the regulations, but most new comparability plan sponsors will benefit from the “gateway” requirement. In general, the proposed regulations provide that a new comparability plan satisfies the gateway requirement if each eligible NHCE receives an allocation rate of at least 5% of compensation. A lower minimum allocation rate could be offered to NHCEs if one-third of the highest allocation rate under the

plan is less than 5%. For example, if an employer maintains a new comparability plan with separate allocation rates for HCEs of 12% and NHCEs of 4%, the plan would satisfy the gateway test.

The proposed regulations are effective for plan years beginning on or after January 1, 2002, regardless of when the new comparability plan design was adopted. If you currently sponsor a new comparability plan or are interested in adopting such a plan, now is the time to call to review plan designs to assure compliance with the new rules for the 2002 plan year.

### **IRS APPROVES ELIMINATION OF CERTAIN DISTRIBUTION OPTIONS**

Code Section 411(d)(6) contains provisions, known as the “anti-cutback” rules, that prevent an employer from amending a qualified retirement plan to reduce a participant’s accrued benefit or to eliminate an optional form of benefit.

An optional form of benefit is a plan provision which relates to the timing, form, or medium of distribution. The anti-cutback rules applied only to benefits accrued before a plan amendment. Therefore, a plan which offered multiple distribution options had to protect those options with respect to existing account balances. The anti-cutback rules were particularly burdensome when an employer merged two plans, such as in conjunction with a merger of employers, because the surviving plan had to preserve all of the “pre-merger” benefit options.

The IRS has issued final regulations permitting modification of the distribution options from defined contribution plans. These regulations modify the rules under Treas. Reg. Section 1.411(d)-4 concerning

optional forms of benefit, by permitting non-pension defined contribution plans (for example, profit sharing and 401(k) plans) to be amended to eliminate the joint and survivor annuity (“J&S”) as an optional form of benefit.

### **Elimination of Forms of Distributions**

Under the final anti-cutback regulations, an employer may amend a plan to eliminate a form of payment as long as the plan provides a single sum distribution option which is otherwise identical to the form being eliminated. A single sum payment is identical to an installment payment provided the payment conditions, payment commencement date and payment medium are the same as for the installment payment. For example, if an employer sponsors a profit sharing plan with lump sum and installment distribution options available after separation from service, the employer may amend the plan to eliminate the installment option as long as the lump sum option is still available after separation from service. Furthermore, the regulations permit an employer to amend a plan to eliminate J&S provisions from a profit sharing plan (including a 401(k) plan). The employer may eliminate the J&S provisions irrespective of whether the J&S form is the normal form of benefit or an optional form of benefit.

The final regulations are effective September 6, 2000, and apply to plan amendments occurring on or after September 6, 2000. To protect participants who may rely on pre-amendment plan terms, the final regulations prohibit application of an amendment to eliminate or restrict an optional form of benefit where a participant’s annuity starting date is more than 90 days before the

participant receives a proper notice of the amendment. For example, assume an employer amends a plan on May 15, 2001 to allow only a single sum distribution option. If proper notice is given to participants at the same time the amendment is adopted, the new provision could become effective as early as August 14, 2001. If notice is not given to participants, the provision will not be effective until the first day of the second plan year following the plan year in which the amendment is adopted. In this example, January 1, 2003 would be the effective date of the new provision.

We recommend that plan sponsors use the new rules to eliminate excessive and overly complex optional forms of distribution during the GUST amendment and restatement process. In addition, we hope to see elimination of optional forms of distribution in a number of other contexts. For example, in a merger and acquisition situation, assume that an acquiring company sponsors a 401(k) plan that provides only for lump sum distribution of benefits, while the target company has a 401(k) plan with a wide range of distribution options, including annuities. Under the new rules, the two plans can be merged and the distribution options in the acquired plan can be eliminated (other than the lump sum), subject to the effective date limitations.

A more common example would be a 401(k) plan which provides for annuities and is thereby subject to the J&S requirements. By eliminating the J&S provisions, the plan will be simpler and less expensive to administer.

**PROPOSED REGULATIONS  
SIMPLIFY REQUIRED  
MINIMUM DISTRIBUTION  
RULES**

In January 2001, the IRS issued proposed regulations regarding the required minimum distribution ("RMD") rules of Code §401(a)(9). These new regulations made substantial changes to the 1987 proposed regulations under which current RMDs are calculated. The RMD rules consist of lifetime distribution rules, which require distributions during an employee's lifetime, and death distribution rules, which require distributions of an employee's account balance that exists at the time of the employee's death. The lifetime distribution rules do not require distributions to commence before an employee's required beginning date ("RBD"). The death distribution rules vary depending upon whether the employee's death occurs before or after the employee's RBD. Unless an employee is a more than 5% owner of the employer, the employee's RBD is the April 1 following the calendar year in which occurs the later of: (1) the employee's attainment of age 70 ½; or (2) the employee's retirement date. For an employee who is a more than 5% owner of the employer, the RBD is the April 1 following the calendar year in which the employee attains age 70 ½.

**Lifetime Distributions**

Under the 1987 proposed regulations, a plan had to make RMD payments over the lives of the employee and designated beneficiary (or over a period not exceeding their joint life expectancies) and also had to limit the extent to which a non-spouse beneficiary who is younger than the employee may be taken into account.

Under the new proposed regulations, a plan will determine RMD amounts during the life of an employee based upon the actual age of the employee in the distribution year, including the year of death. The life expectancy of the employee's designated beneficiary is not taken into account, except where the employee designates his or her spouse as beneficiary, and the spouse is more than 10 years younger than the employee. In this case, the employee's lifetime RMDs are computed based on the joint life expectancies of the employee and spouse. The effect of this change is to simplify the lifetime RMD computation and to reduce the RMD amount for most employees. In addition, an employee will be able to change beneficiaries after the required beginning date ("RBD") without increasing the RMD amounts.

**Post Death Distributions**

The 1987 proposed regulations provide that for an employee who dies after the required beginning date ("RBD"), the plan must distribute the remaining account under a method

which is at least as rapid as that in effect at the time of death. If the employee dies prior to the RBD, the plan must distribute the remaining account balance over the life expectancy of the designated beneficiary (commencing within 1 year of death) or within 5 years of the employee's death. A surviving spouse designated beneficiary may postpone commencement of the RMDs until the date the employee would have reached age 70½. Under the new proposed regulations, irrespective of whether the employee's death occurs before or after the RBD, the designated beneficiary may receive the remaining payments over the beneficiary's remaining life expectancy.

These proposed regulations are generally effective for calendar years beginning on or after January 1, 2002. Sponsors of qualified retirement plans that want to make RMDs for the 2001 calendar year based on the newly proposed regulations may do so. The decision to apply the new RMD rules can be made before any RMDs are calculated for the 2001 calendar year or, if some RMDs have already been made, plan sponsors can indicate a special effective date for all future RMD calculations. We will need to await further direction from the IRS before we can add language to plan documents incorporating the new regulations.

**QUESTIONS?**

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