

EDUCATION AND EXAMINATION COMMITTEE

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COURSE EA-2, SEGMENT B, STUDY NOTE

SUMMARY OF ECONOMIC GROWTH AND TAX RELIEF

RECONCILIATION ACT (EGTRRA) OF 2001

PROVISIONS RELATION TO PENSION AND PROFIT-SHARING PLANS

by

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This summary of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) has been included in the study note package to cover changes in the law that occurred after many of the other study notes were written.

EGTRRA

Economic Growth and Tax Relief Reconciliation Act of 2001 Provisions relating to Pension and Profit-Sharing Plans

Summary sponsored by the Society of Actuaries

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0. Introduction

The Economic Growth and Tax Relief Reconciliation Act of 2001 ('EGTRRA' [P.L. 107-16]), enacted June 7, 2001, includes numerous changes to rules for pensions and benefits. For any defined benefit plans currently contemplating plan amendments, the most immediate concern may be the new rules for

participant notices of accrual reductions. Defined benefit plans with non-calendar limitation years have higher benefit ceilings beginning in 2001, while numerous other ceilings increase in 2002.

All of EGTRRA's changes might be temporary: the law includes a sunset provision that returns everything to pre-EGTRRA status beginning in 2011. Whether or not some or all provisions of EGTRRA are eventually extended, the sunset provision might affect current administration, transactions, and decisions.

For relevant source text, see the Library of Congress website.

1. Notice of Benefit Accrual Reduction Amendments

Written notice to affected plan participants is required regarding plan amendments that significantly reduce the rate of future benefit accruals. Plan amendments that eliminate or significantly reduce early retirement benefits or retirement-type subsidies will be treated as significantly reducing future benefit accruals.

The notice must provide sufficient information to enable recipients to understand the effect of the amendment. It must be provided within a reasonable time before the amendment's effective date. Until publication of IRS regulations, reasonable good-faith interpretation should be used for compliance with the content and timing requirements.

An excise tax is imposed on the employer (or on the plan in the case of a multiemployer plan) for failure to meet the notice requirement. The excise tax is \$100 per day for each individual for whom the notice requirement was not met. If reasonable diligence was exercised, the excise tax is capped at \$500,000 per year. The IRS has authority to waive the excise tax when appropriate.

If failure to provide the required notice is egregious, then applicable individuals are entitled to the greater of plan benefits without the amendment or plan benefits under the amendment.

Effective Date: plan amendments effective on or after 6/7/2001. The period for providing the notice will not end prior to 9/7/2001. Until issuance of Treasury regulations, reasonable good-faith is to be used for compliance with the content and timing requirements.

Citations: EGTRRA §659, adding IRC §4980F and amending ERISA §204(h).

2. Benefits and Contributions

a. Limits and Thresholds

i. Dollar-Based Benefit and Contribution Limitations Increased

Defined Benefit Ceiling Increased to \$160,000

Beginning in 2001 for non-calendar limitation years or in 2002 for calendar limitation years, the dollar

limitation on annual benefits under a defined benefit plan is increased to \$160,000. For later years, indexation relies on a base quarter beginning July 1, 2001, and is made in \$5,000 increments.

Adjustments are not made to the ceiling for benefit commencement at any age from 62 through 65. Actuarial adjustments are made to the ceiling for benefit commencement prior to age 62 or later than age 65.

Note that for multiemployer plans, EGTRRA also changed the compensation-based limitation on benefits.

Effective Date: years *ending* on or after January 1, 2002.

Citations: EGTRRA §611(a), amending IRC §415(b).

Defined Contribution Ceiling Increased to \$40,000

Beginning in 2002, the dollar limitation on annual additions under a defined contribution plan is increased to \$40,000. For later years, indexation relies on a base quarter beginning July 1, 2001, and is made in \$1,000 increments. Note that EGTRRA also changed the compensation-based limitation on annual additions. Changes were also made by EGTRRA to the limitations applicable to certain components of annual additions, notably to the ceiling on elective deferrals.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §611(b), amending IRC §(c)(1)(A).

Phased-In Increase in Ceiling on Elective Deferrals

The annual dollar ceiling on elective deferrals under §401(k) plans, §403(b) annuities, and §408(k) salary reduction SEPs is increased to \$11,000 for 2002. Through 2006, the ceiling increases each year in \$1,000 increments, to \$15,000 in 2006. For subsequent years, indexation relies on a base quarter beginning July 1, 2005, and is made in \$500 increments.

Similarly, the annual dollar ceiling on elective deferrals to a SIMPLE plan is increased to \$7,000 in 2002, increasing by \$1,000 each year until reaching \$10,000 in 2005. For subsequent years, indexation relies on a base quarter beginning July 1, 2004, and is made in \$500 increments.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §611(d), amending IRC §402(g)(1); EGTRRA §611(f), amending IRC §402(p)(2).

Deferrals under §457 Deferred Compensation Arrangements

The annual dollar ceiling on deferrals under a §457 deferred compensation arrangement maintained by a tax-exempt organization or a state or local governmental employer is increased to \$11,000 for 2002. Through 2006, the ceiling increases each year in \$1,000 increments, to \$15,000 in 2006. For subsequent years, indexation relies on a base quarter beginning July 1, 2005, and is made in \$500 increments.

The limitation for an individual during the three taxable years period preceding attainment of the plan's normal retirement age is twice the otherwise applicable limit.

The rule that had required coordination of §457 deferrals with deferrals and contributions under other plans is repealed.

Note that EGTRRA also modified the compensation-based limitation on §457 deferrals.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §611(e), amending IRC §§457(b), 457(e)(15)(A). EGTRRA §615, amending IRC §§457(c).

ii. Compensation Ceiling Increased

The ceiling on compensation used for determination of contributions or benefits under a plan is increased to \$200,000, beginning in 2002. In subsequent years, indexation relies on a base quarter beginning July 1, 2001, and is made in \$5,000 increments. A corresponding change was made in the ceiling on compensation used for purposes of deductibility.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §611(c)(1), amending IRC §401(a)(17).

iii. Compensation-Based Benefit Limitation Eliminated for Multiemployer Plans

The 100%-of-compensation limit on benefits is repealed for multiemployer plans. Conforming rules are provided for aggregation rules applicable to the limitations.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §654, amending IRC §§415(b)(11), 415(f)(3).

iv. Compensation-Based Contribution Limitation Increased to 100%

The compensation-based §415 limitations on annual additions is increased to 100%. Note that EGTRRA also modified the dollar-based ceiling for annual additions.

The compensation-based ceiling on deferrals under a §457 deferred compensation arrangement is similarly increased to 100%. Note that EGTRRA also modified the dollar-based ceiling for §457 arrangements.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §632(a)(1), amending IRC §415(c)(1)(B). EGTRRA §632(c), amending IRC §457(b)(2)(B).

v. Limitations for 403(b) Tax-Sheltered Annuities

The exclusion allowance limitation is repealed. A §403(b) tax-sheltered annuity is to be treated as a defined contribution plan, subject to the §415(c) limitations on annual additions.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §632(a)(2), amending IRC §403(b).

b. Catch-Up Elective Deferrals

A plan may be amended to permit additional elective deferrals to be made by any plan participant who is age 50 or more by the close of the plan year. Catch-up elective deferrals made during the year cannot exceed the compensation for the year, reduced by other elective deferrals. For plans other than those described in §401(k)(11) or SIMPLE plans, the annual dollar ceiling on catch-up elective deferrals is \$1,000 for 2002. Through 2006, the ceiling increases by \$1,000 each year, to a ceiling of \$5,000 in 2006. For subsequent years, indexation relies on a base quarter beginning July 1, 2005, and is made in \$500 increments.

For plans described in §401(k)(11) or SIMPLE plans, the annual dollar ceiling on catch-up elective deferrals is \$500 for 2002. Through 2006, the ceiling increases by \$500 each year, to a ceiling of \$2,500 in 2006. For subsequent years, indexation relies on a base quarter beginning July 1, 2005, and is made in \$500 increments.

An individual age 50 or over is not eligible to make a catch-up until the individual's other elective deferrals have been restricted by either a statutory ceiling or by a comparable plan limit. If an individual is given the right under a plan to make a catch-up elective deferral, then all eligible plan participants in all qualified plans of the employer's controlled group must be given the right to make catch-up elective deferrals. Catch-up elective deferrals are not taken into account for the otherwise applicable nondiscrimination or coverage requirements, §415 limitations on contributions, or deduction limits.

A plan may provide employer matching contributions based on catch-up elective deferrals. Any such matching contributions are subject to all otherwise applicable requirements, including the nondiscrimination requirements, §415 limitations on contributions, and deduction limits.

Effective Date: beginning on or after January 1, 2002.

Citations: EGTRRA §631, adding IRC §414(v).

c. Other Provisions on Benefits and Contributions

i. 401(k) Elective Deferrals Permitted 6 Months After Hardship Distribution

Effective Date: beginning on or after

Citations: EGTRRA §, amending IRC § and ERISA §.

ii. Retirement Plans for Self-Employed Members of Certain Religious Sects

For purposes of qualified plans, the definition of compensation includes net earnings that is not subject to self-employment tax on account of a religious exemption claimed by the individual under IRC §1402 (g).

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §611(g), amending IRC §§401(c)(2)(A), 408(p)(6)(A).

3. Vesting, Top-Heavy Rules, and Nondiscrimination

a. Accelerated Vesting Schedule for Matching Contributions

The minimum vesting requirements are accelerated for employer matching contributions. A participant's nonforfeitable right to amounts attributable to employer matching contributions must satisfy either of two vesting schedules:

1. *Cliff Vesting*—Employer matching contributions must be 100% vested after 3 years of service.
2. *Graded Vesting*—Employer matching contributions must be 20% vested after 2 years of service. For each year thereafter, the vesting percentage must increase by 20%. After completion of 6 years of service, the vesting percentage must be 100%.

Effective Date: years beginning on or after January 1, 2002. An extended effective date is available for plans maintained under a collective bargaining agreement.

Citations: EGTRRA §633, amending IRC §411(a)(2) and ERISA §203(a)(2), and adding IRC §411(a)(12) and ERISA §203(a)(4).

b. Modification of Top-Heavy Plan Rules

The top-heavy rules are modified--

- Safe harbor 401(k) plans are deemed to satisfy the top-heavy rules.
- Employer matching contributions are taken into account for purposes of satisfaction of the top-heavy minimum benefit rules.
- The definition of key employee has been simplified.
- Except for in-service distributions (for which the five-year look-back period has been retained), only distributions within the prior year must be taken into account.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §613, amending IRC §416.

c. Nondiscrimination

i. Repeal of Multiple Use Test for 401(k)/(m)

The multiple use test is repealed after 2001. For employers performing both the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test, those tests will now be performed separately and independently, without the additional restriction that had been imposed by the multiple use test.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §666, amending IRC §401(m)(9).

ii. Exclusion of Certain Tax-Exempt Charity Employees from Nondiscrimination Testing

For a tax-exempt charitable organization, employees who are eligible to contribute to a 403(b) plan may be treated as excludable with respect to a 401(k) plan or a similar arrangement subject to 401(m), provided certain conditions are met.

Effective Date: tax years beginning on or after January 1, 1997.

Citations: EGTRRA §664.

4. Funding and Deductibility

a. Timing of Actuarial Valuation

Codifying proposed regulations, the actuarial valuation date must be during the plan year or within one month prior to the beginning of the plan year.

Determination of gains and losses and valuation of the plan's liability may be made as of a date during the prior plan year, provided that plan assets on that date were at least 125% of current liability. Values on that basis must be actuarially adjusted to reflect significant differences in participants.

Effective Date: plan years beginning on or after January 1, 2002.

Citations: EGTRRA §661, amending IRC §412(c)(9) and ERISA §302(c)(9).

b. Phased Repeal of Current Liability Full Funding Limit

For 2002, the applicable percentage of current liability used for the full funding limit increases to 165 percent. In 2003, the applicable percentage increases to 170 percent. For 2004 and later, the component of full funding limit that is based on current liability is repealed.

For any contributions during 2002 and 2003 in excess of the current liability full funding limit, EGTRRA included a provision permitting an election to disregard any excise tax with respect to nondeductible contributions in excess of the current liability full funding limit.

Effective Date: plan years beginning on or after January 1, 2002.

Citations: EGTRRA §651, amending IRC §412(c)(7) and ERISA §302(c)(7).

c. Changes in Deduction Limits

i. Defined Benefit Deductibility Limit At Least Unfunded Current Liability

The special rule permitting a deduction for employer contributions of up to the unfunded current liability is available to all defined benefit plans. For plans with 100 or less participants for the plan year, the current liability for purposes of this deduction rule does not include liability attributable to benefit increases for highly compensated employees that were made or became effective within the previous

two years. For the year in which a plan terminates, the plan may deduct the amount required to make the plan sufficient for all plan liabilities.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §652, amending IRC §404(a)(1)(D).

ii. Deduction Limit Increased to 25% for Defined Contribution and Money Purchase Plans

The limit on deductible contributions to a defined contribution plan is increased to 25% of compensation. For a money purchase plan, the employer may deduct up to the greater of 25% of compensation or the amount required to be contributed under the minimum funding standards.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §616(a)(1)(A), amending IRC §404(a)(3)(A)(i)(I). EGTRRA §616(a)(2), amending IRC §404(a)(3)(A)(iv).

iii. Increase in Ceiling on Compensation-Based Deduction Limit

The ceiling on compensation used for the compensation-based limit on deductibility is increased to \$200,000, beginning in 2002. In subsequent years, indexation relies on a base quarter beginning July 1, 2001, and is made in \$5,000 increments. A corresponding change was made to the general ceiling on compensation.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §611(c), amending IRC §404(l).

iv. Compensation for Deduction Limits Includes Salary Reduction Amounts and Pre-Disability Compensation

For purposes of the compensation-based limitations on deductible contributions, the following amounts are included:

- *Elective Deferrals*—Elective deferrals to a §401(k) cash or deferred arrangement, a SEP, a salary reduction 403(b) annuity, or a SIMPLE retirement account.
- *Other Non-Taxable Benefits*—Excludable amounts contributed to a §125 cafeteria plan, a §132(f) qualified transportation fringe benefit plan, or a §457 deferred compensation arrangement.
- *Pre-Disablement Wages*—Wages at the rate prior to permanent and total disablement, if the employer is making contributions on the basis of such imputed compensation under IRC §415(c)(3)(C).

Conforming changes were made to the compensation referenced in the tax on nondeductible contributions, as governed by IRC §4972.

As noted below, EGTRRA separately excluded elective deferral amounts from the deduction limits.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §616(b), adding IRC §404(a)(12).

v. Elective Deferrals Excluded from Deduction Limits

For purposes of the deduction limitations, certain elective deferrals are no longer treated as employer contributions. Although still deductible, the following are not included in applying the limitations on the deduction:

- Elective deferrals to a §401(k) plan;
- Salary reduction contributions to a §408(k)(6) SARSEP;
- Salary reduction contributions to a §403(b) tax-sheltered annuity; or
- Elective deferrals under a §408(p) SIMPLE account.

Note that EGTRRA separately modified the definition of compensation used for purposes of the deduction limits to include salary deferral amounts.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §614(a), adding IRC §404(n).

vi. Elective Exemption from Excise Tax on Nondeductible Contributions

For purposes of the excise tax on nondeductible contributions, an employer may elect to disregard contributions to a defined benefit plan not in excess of the accrued liability full funding limitation. After 2003, the current liability full funding limit will be repealed; thus, this excise tax election will become irrelevant.

Effective Date: plan years beginning on or after January 1, 2002.

Citations: EGTRRA §653, adding IRC 4972(c)(7).

vii. Multiemployer Plan Accounting Method Disallowed

An employer's change in application of the timing rule of §404(a)(6) for a multiemployer pension plan is not a method of accounting.

Effective Date: plan years ending on or after June 8, 2001.

Citations: EGTRRA §658.

viii. Waiver of Tax on Nondeductible Contributions for Household Workers

The 10% excise tax on nondeductible contributions is waived when the sole reason that the contribution is considered nondeductible is that it is not made in connection with the employer's trade or business.

Effective Date: years beginning on or after January 1, 2002.

Citations: EGTRRA §637(b), amending IRC §4972(c)(6).

5. Distributions, Rollovers, and Intra-Plan Transactions

a. Automatic Rollover of Involuntary Cashout Over \$1,000

An involuntary distribution that exceeds \$1,000 must be automatically rolled over to an IRA designated by the plan sponsor, unless the plan participant affirmatively elects otherwise.

Effective Date: distributions made after issuance of final regulations from the Department of Labor (to be within 3 years after the EGTRRA effective date).

Citations: EGTRRA §657, inserting IRC §401(a)(31)(B) and amending IRC §402(f)(1)(A) and ERISA §404(c)(3).

b. Changes in Rollover Rules

i. Hardship Distribution Ineligible for Rollover Treatment

c. Other Changes in Distribution Rules

i. Revision of Life Expectancy Tables for Required Minimum Distribution

ii. QDRO Treatment for 457 Plan Domestic Relations Orders

iii. Plan Loans to Executives Not Prohibited Transactions

iv. Distribution Treatment for ESOP Allocations of S Corporation Employer Stock to Disqualified Persons

6. IRAs and ESOPs

a. IRAs in Qualified Plans

i. Deemed IRAs

ii. Roth-Type Elective Deferrals

A §401(k) plan or a §403(b) tax-sheltered annuity will be permitted to include a qualified Roth contribution program. Under such a program, participants may elect to have elective deferrals designated as after-tax Roth contributions. Like Roth IRAs, Roth contributions would accumulate tax-free and would be exempt from income tax upon distribution. Due largely to the complexity anticipated of such accounts, qualified Roth contribution programs are not permissible until 2006.

Effective Date: tax years beginning on or after January 1, 2006.

Citations: EGTRRA §617, adding IRC §402A.

b. IRAs

i Increase in IRA Contribution Limits ii. IRA Catch-Up Contributions

c. ESOPs

i. Investment of Employee's Contributions in 401(k) Plan

The diversification requirement of §1524(b) of the Taxpayer Relief Act of 1997 does not apply to elective deferrals invested in qualifying employer securities or qualifying employer real property acquired before January 1, 1999.

Effective Date: elective deferrals for plan years beginning on or after January 1, 1999.

Citations: EGTRRA §655, amending TRA97 §1524(b).

7. Tax Credits and User Fees

a. Tax Credits

i. Individual Tax Credit

A nonrefundable tax credit is available to individuals for contributions or deferrals made to a qualified retirement plan. The tax credit is equal to 50% of contributions up to \$2000 for single taxpayers with adjusted gross income up to \$15,000 or joint filers with adjusted gross income up to \$30,000. Above those income levels, the tax credit is phased out.

Effective Date: tax years beginning on or after January 1, 2002, and before January 1, 2007.

Citations: EGTRRA §618, adding IRC §25B.

ii. Small Employer Credit for Pension Startup Costs

An employer with 100 or fewer employees will receive a tax credit for 50% of the start-up costs for creation or maintenance of a new qualified retirement plan. The tax credit is limited to \$500 per year for any of the three years beginning with the year during which the plan becomes effective.

Effective Date: tax years beginning on or after January 1, 2002, with respect to plans established on or after that date.

Citations: EGTRRA §619, adding IRC §45E and making conforming amendments.

b. Waiver of Determination Letter User Fees for Small Employers

User fees are waived for determination letter requests made by a small employer within the first five years of a plan's existence (or within any remedial period beginning within the first five years, if later).

Effective Date: requests made on or after January 1, 2002.

Citations: EGTRRA §620.

8. Miscellaneous

a. Qualified Retirement Planning Services

b. Credit for Employer-Provided Child Care Expenses

c. Adoption Credit and Employer Assistance Exclusion

d. Educational Assistance Programs

e. Qualified Tuition Programs

f. Education IRAs

9. Sunset Provision

In order to win congressional passage and assure presidential approval of EGTRRA, the reconciliation package includes a sunset provision. All provisions of EGTRRA are not applicable for years beginning after 2010, unless eventually extended by further legislative action. If any provision is not extended or made permanent, then the provisions of the tax code and ERISA revert to the rules that were applicable prior to the effective dates of EGTRRA.

Citations: EGTRRA §901.
