

Client Alert

A report
for clients
and friends
of the firm October 2001

Plan Sponsor Action Required Prior to January 1, 2002 Due to New IRS Guidance Under EGTRRA

As we reported in our June Client Alert, on June 7, 2001, President Bush signed into law The Economic Growth and Tax Relief Reconciliation Act of 2001 (referred to as "EGTRRA"). The Internal Revenue Service ("IRS") recently issued guidance concerning the application of certain EGTRRA provisions to qualified retirement plans. This Client Alert describes the required EGTRRA changes which must be made to qualified retirement plans in 2002 and the attached EGTRRA Decision Checklist describes the optional EGTRRA changes which may be made to qualified retirement plans in 2002. ***Plan sponsors should carefully consider these changes as soon as possible since some changes may require that plans be amended before the end of the 2001 plan year; failure to amend prior to January 1, 2002 may result in unintended increases in benefits which may not be decreased or eliminated at a later date.***

We suggest that you complete the attached EGTRRA Decision Checklist to help you determine which optional changes you wish to make to your qualified retirement plan and return it to your employee benefits attorney at Proskauer. While we will be pleased to work with you, plan sponsors should also confer with third party administrators and service providers in their analysis of the applicable EGTRRA changes to determine the costs of implementing such changes. A copy of this Client Alert, the EGTRRA Decision Checklist and our June Client Alert can be accessed at www.proskauer.com.

Good Faith EGTRRA Plan Amendments

In its recent guidance, the IRS provided sample amendments that can be used by plan sponsors to comply with the requirement to adopt "good faith" EGTRRA plan amendments on a timely basis. These sample amendments may need to be tailored to conform with the individual plan. Although the sample amendments are designed for plans qualified under Section¹ 401(a), the IRS has stated that some of the sample amendments may be appropriate for use in 403(b) plans. In general, the EGTRRA plan amendments described herein must be timely adopted before the end of the 2002 plan year. ***In certain cases, however, earlier adoption may be necessary in order to avoid an automatic increase in benefits.*** In any case, plans which have not yet been updated to comply with the recent legislation known as "GUST" (which, in most cases, must be done by the end of the 2001 plan year) may be simultaneously amended to include the good faith EGTRRA amendment.

A plan amendment will only be considered a good faith EGTRRA plan amendment if the amendment represents a reasonable effort to take into account all of the requirements of the applicable EGTRRA provision. In addition, the operation of the plan must reflect a reasonable interpretation of EGTRRA and must be consistent with any published guidance after the effective date of such guidance. The IRS has indicated that it will issue additional guidance on certain EGTRRA changes in the future. The sample amendments recently issued by the IRS will continue to be good faith EGTRRA plan amendments even after the publication of additional guidance.

EGTRRA Amendments

The following describes the required qualified retirement plan changes that must be made pursuant to EGTRRA for the 2002 plan year. The optional changes are described in the attached EGTRRA Decision Checklist.

- **Maximum Limits on Contributions.** Defined contribution plans must be amended to reflect the increased maximum annual addition limitation under Section 415(c) (unless such provision is properly incorporated by reference).

¹ All references to the term "Section" are to sections of the Internal Revenue Code of 1986, as amended.

- **Repeal of Maximum Exclusion Allowance.** 403(b) plans must be amended to reflect the repeal of the maximum exclusion allowance.
- **Top-Heavy Rules.** All plans must be amended to reflect the new top-heavy rules. In the case of plans which consist solely of 401(k) contributions and safe-harbor matching contributions, the amendment must provide that the top-heavy rules do not apply in any plan year after December 31, 2001. Recent IRS guidance provides that the EGTRRA amendments apply for purposes of determining whether a plan is top-heavy for the first plan year beginning after December 31, 2001, even though the determination date for that plan year is before the effective date of the EGTRRA amendment.
- **Rollovers.** The rollover provisions of all plans must be amended to include as "eligible retirement plans" for direct rollovers from the plan both 403(b) arrangements and 457(b) plans maintained by state or local governments. The definition of "eligible rollover distribution" must be amended to exclude any hardship distribution and, if applicable, must be amended to include after-tax contributions. The spousal rollover rules must also extend to a spouse or former spouse under a qualified domestic relations order.
- **Repeal of Multiple Use Test.** 401(k) plans must be amended to reflect the repeal of the multiple use test.
- **Vesting of Matching Contributions.** All plans which provide for matching contributions must provide for vesting of such contributions at a rate that is at least as rapid as a 3 year cliff vesting schedule or a 2 to 6 year graded vesting schedule, at the rate of 20% each year.
- **Elective Deferrals.** Sponsors of 401(k) plans and 403(b) plans who wish to apply the increased limit on elective deferrals should confirm that the elective deferral limit under Section 402(g) is properly incorporated by reference.
- **Plan Loans.** The rule prohibiting loans to owner-employees or shareholder-employees has been repealed.
- **Hardship Distributions.** Plans which rely on the design-based matching contribution safe harbor under the Code must reduce the suspension period for making employee contributions following a hardship distribution from 12 months to 6 months. The reduction from 12 to 6 months is optional for all other defined contribution plans.
- **Maximum Limits on Benefits.** Defined benefit plans must be amended to reflect the increased benefit dollar limitation under Section 415(b) from \$140,000 to \$160,000 (unless such provision is properly incorporated by reference). This increase is effective for limitation years beginning on January 2, 2001 or later; accordingly, with regard to plans which do not use the calendar year as the limitation year, this change may already be in effect. Further, this limit is no longer decreased between age 62 and social security retirement age or increased between age 65 and social security retirement age, resulting in possible increased costs. You should consult with your actuary as to the impact of the 415(b) changes on

your plan. Multiemployer defined benefit plans need to be amended if they wish to take advantage of the repeal of the 100% of compensation limit on benefits (unless the Section 415 benefit limits are properly incorporated by reference).

Future Guidance

As noted above, the IRS has stated that additional guidance on EGTRRA will be provided. Plans amended by the timely adoption of good faith EGTRRA plan amendments, including the sample amendments, may need to be amended again by the end of the EGTRRA remedial amendment period to comply with additional guidance. The IRS has also stated that, until further notice, it will not consider EGTRRA in issuing determination letters. We will continue to keep you informed as the IRS issues further guidance on the implementation of EGTRRA changes.

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Client Alert

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This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice or render a legal opinion.

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EGTRRA DECISION CHECKLIST

This checklist is designed to assist plan sponsors with regard to the decisions that they need to make under The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") prior to the first day of the plan year beginning in 2002 (January 1, 2002 for calendar year plans). This checklist is not a legal document and, therefore, is not binding on the plan sponsor; rather, it is intended to facilitate the process for determining whether certain formal plan amendments are necessary or desirable.

Please complete the following checklist and return it to your employee benefits attorney at Proskauer. Once we receive the completed checklist, we will contact you to begin the EGTRRA plan amendment process. If you need further assistance or would like to discuss the relevant issues, please contact your employee benefits attorney at Proskauer or any of the Proskauer attorneys listed at the end of the attached Client Alert.

1. COMPENSATION LIMIT [IRC § 401(a)(17)].

If Box a2 or b2 is selected, this change will likely have to be adopted prior to the commencement of the 2002 plan year to avoid an automatic increase in benefits which may not be decreased or eliminated at a later date.

a. General Rule.

1. ☐ Increase compensation for purposes of calculating benefits or contributions to reflect the EGTRRA maximum limit of \$200,000 per year, effective for the 2002 plan year, adjusted in subsequent years in increments of \$5,000 for inflation (note that a plan amendment may not be required if the plan incorporates the 401(a)(17) limit by reference in a certain manner).
2. ☐ Do not increase compensation for purposes of calculating benefits or contributions and continue to limit compensation to the current annual limit of \$170,000 (without adjustment for inflation).

Alternative Dollar Limit: \$ _____ (must not be greater than \$200,000, as adjusted).

b. Special Rule for Plans Using Average Compensation. If your plan utilizes an "average" of various years' compensation for purposes of calculating contributions or benefits (e.g., final average compensation over a 5 year period), please check one of the following (note that this generally will be applicable only to defined benefit plans):

1. ☐ Apply the \$200,000 compensation limit to all compensation used in calculating benefits accrued or contributions made in plan years beginning on or after January 1, 2002 (including compensation paid prior to the 2002 plan year) (note that this approach will provide an increased benefit under the plan and will have an impact on the funded status of the plan).
2. ☐ Apply the \$200,000 compensation limit only to the annual compensation paid in plan years beginning on or after January 1, 2002 but not to compensation paid prior to the 2002 plan year.
3. ☐ N/A. Plan does not utilize average compensation.

2. 401(k) AND 403(b) PLANS ELECTIVE DEFERRAL LIMIT [IRC § 402(g)].

If Box 2 is selected, this change will likely have to be adopted prior to the commencement of the 2002 plan year to avoid an automatic increase in contributions to the plan.

1. ☐ Increase elective deferrals to reflect maximums permitted by EGTRRA:

<u>Year</u>	<u>Limit</u>
2002	\$11,000
2003	\$12,000
2004	\$13,000
2005	\$14,000
2006	\$15,000

After 2006, the maximum elective deferral is indexed for inflation in \$500 increments (note that a plan amendment may not be required if the plan incorporates the 402(g) limit by reference in a certain manner).

2. ☐ Retain current maximum elective deferral limit of \$10,500 without further adjustment (note that most plan sponsors will not adopt this approach and a plan amendment may be required prior to January 1, 2002, if the plan incorporates the 402(g) limit by reference in a certain manner).

3. ANNUAL ADDITION LIMITS UNDER DEFINED CONTRIBUTION PLANS [IRC § 415(c)].

EGTRRA increases the maximum limit for contributions allocated to a participant's account to the lesser of 100% of compensation or \$40,000 (increased in subsequent years in \$1,000 increments for inflation). Plan sponsors may wish to increase the formula under their plans to take advantage of this increase or retain their current formula. **If the plan's formula incorporates Section 415(c) in a certain manner, a plan amendment may be required prior to the commencement of the 2002 plan year to avoid an automatic increase in contributions to the plan.**

1. ☐ Retain current formula.
2. ☐ Change formula to use maximum 415(c) limit.
3. ☐ Change formula to use a different formula (must be less than the lesser of 100% of compensation or \$40,000 (as adjusted)). Describe:

4. CATCH-UP CONTRIBUTIONS - 401(k) AND 403(b) PLANS [IRC § 414(v)].

a. 401(k) and 403(b) Plans.

1. ☐ Permit catch-up contributions to the fullest extent permitted under EGTRRA. (Participants who are age 50 and over may make catch-up contributions of up to \$1,000 for 2002 and increasing by \$1,000 each year until reaching \$5,000 in 2006 and as subsequently adjusted in \$500 increments for inflation).
2. ☐ No catch-up permitted for 2002 (note that plan sponsors may wish to wait for further IRS guidance before adopting a catch-up provision).

b. Plans with Matching Contributions.

1. ☐ Do not match catch-up contributions (generally recommended approach pending further IRS guidance).
2. ☐ Match catch-up contributions as follows (note that the nondiscrimination rules may limit the ability to make an additional matching contribution):

5. VESTING SCHEDULE FOR MATCHING CONTRIBUTIONS [IRC § 411(a)(12)].

a. Vesting Schedule

In order to determine the appropriate method for adjusting the plan's vesting schedule for matching contributions, please describe the current vesting schedule for matching contributions (note that special issues will apply if your current vesting schedule is more generous than the EGTRRA-prescribed vesting schedules and you wish to change your plan's vesting schedule):

Change the vesting schedule as follows:

1. ☐ EGTRRA-prescribed 3 year cliff vesting (0% vesting up to the 3rd year; 100% vesting at the 3rd year).
2. ☐ EGTRRA-prescribed 2 to 6 year graded schedule (20% vesting each year commencing at the 2nd year).
3. ☐ More generous vesting schedule. Describe:

b. Application of New Vesting Schedule.

1. ☐ Apply new schedule to new matching contributions only (*i.e.*, relating to plan years beginning on and after January 1, 2002).
2. ☐ Apply new schedule to all matching contributions.

c. Application to Participants.

1. ☐ Apply new schedule to participants with service following amendment (*i.e.*, beginning with the 2002 plan year) (generally recommended approach).
2. ☐ Apply new schedule to all participants (*i.e.*, any participant with an account balance regardless of whether the participant terminated employment).

6. CONTRIBUTION SUSPENSION FOLLOWING HARDSHIP WITHDRAWALS - 401(k) AND 403(b) PLANS.

1. ☐ Change to EGTRRA-prescribed suspension of 6 months - no elective contributions for 6 months following receipt of a hardship withdrawal with regard to elective deferrals (note that this is required for plans using a designed-based matching contribution safe harbor).
This change will apply as follows:

☐ With respect to hardship withdrawals made after 2001.
☐ With respect to hardship withdrawals made after 2000.
2. ☐ Retain current 12 month suspension of elective contributions following receipt of a hardship withdrawal.

7. ROLLOVERS.

a. For Plans Requiring \$5,000 Cash-Outs.

1. ☐ Rollover contributions (and earnings thereon) will be disregarded when calculating the \$5,000 cash-out amount as permitted under EGTRRA (generally recommended approach to reduce plan administration and the number of accounts held under a plan).
This provision will apply as follows:

☐ With respect to all distributions made on or after _____ (enter a date no earlier than January 1, 2002).

☐ With respect to participants who separate from service after _____ (enter a date, which may be earlier than January 1, 2002).
2. ☐ Rollover contributions (and earnings thereon) will not be disregarded when calculating the \$5,000 cash-out amount.
3. ☐ N/A. Plan does not provide for cash-outs.

b. Permitted Rollovers. Assuming that your tax-qualified plan accepts rollover contributions from tax-qualified plans and certain IRAs (or, in the case of a 403(b) plan, from other 403(b) plans and certain IRAs), the plan will accept rollover contributions from the following additional types of plans or of the following types of contributions (check all that apply):

1. ☐ 401(a) plans (in the case of 403(b) plans).
2. ☐ 403(b) plans (in the case of tax-qualified 401(a) plans).
3. ☐ 457 plans maintained by state or local governments.
4. ☐ After-tax contributions (need separate accounting).
5. ☐ Spousal beneficiary IRA (note that a plan amendment may not be required if the plan permits rollovers from IRAs).

8. DISTRIBUTION UPON SEVERANCE FROM EMPLOYMENT UNDER 401(k) AND 403(b) PLANS.

1. ☐ Permit distributions of elective deferrals, qualified nonelective contributions, qualified matching contributions and related earnings upon a participant's severance from employment. This change reflects EGTRRA's repeal of the "same desk" rule and permits more flexibility for distributions following certain corporate transactions. This provision will apply for distributions on or after _____ (enter a date not earlier than January 1, 2002) and will apply as follows:

☐ Regardless of when severance from employment occurred.

☐ For severances from employment occurring after _____ (enter date).
2. ☐ Do not permit distributions upon a participant's severance from employment (continue to apply the "same desk" rule; note that this approach may limit distributions following certain corporate transactions).

9. BENEFIT LIMITS UNDER DEFINED BENEFIT PLANS [IRC § 415(b)].

If Box a3 or b1 is selected, this change will likely have to be adopted prior to the commencement of the first limitation year which ends during 2002 to avoid an automatic increase in benefits which may not be decreased or eliminated at a later date. In the case of a plan which uses a limitation year that is not the calendar year, this increase may already be in effect.

a. Changes in the benefit dollar limitation.

While EGTRRA increased the benefit dollar limit to \$160,000, defined benefit plan sponsors may elect to provide benefit increases resulting from the increased limit for the following participants:

1. ☐ Apply to all current and former participants who have an accrued benefit under the plan and whose benefits would have otherwise been limited.
2. ☐ Apply to all employees participating in the plan who complete an hour of service on or after the first day of the 2002 limitation year.
3. ☐ Apply limits in effect prior to EGTRRA.

b. Repeal of the 100% compensation limit (multiemployer plans only).

For multiemployer plans, EGTRRA also repealed the previous limit on benefits of 100% of average compensation for the high three years. The Board of Trustees may elect (subject to the collective bargaining agreement):

1. ☐ To continue to maintain the pre-EGTRRA limitation.
2. ☐ To apply the EGTRRA change so that the only limitation will be the dollar limitation of \$160,000, as adjusted.

* * *

The foregoing checklist describes the optional EGTRRA provisions. Plan documents will also need to be amended to reflect the required EGTRRA provisions.

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Plan Name: _____

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