

Part I

Section 401.---Qualified Pension, Profit-Sharing and Stock Bonus Plans

26 CFR 1.401(a)(17)-1: Limitation on annual compensation.

Rev. Rul. 2003-11

ISSUE

Whether a plan amendment that reflects the increase in the allowable compensation limit contained in section 611(c) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. 107-16, and applies that increase to former employees, will satisfy the nondiscrimination rules of §401(a)(4) and the minimum coverage requirements of §410(b) of the Internal Revenue Code (Code).

FACTS

Plan A is a nongovernmental defined benefit plan with a calendar year plan year and a benefit formula that provides for all participants an annual benefit at normal retirement age equal to the product of: (years of service) x (1 percent) x (high 3-year average compensation). For this purpose, high 3-year average compensation is the average of the compensation over the 3 consecutive plan years for which the average is the highest, and compensation for each year is limited to \$150,000, as adjusted for cost-of-living increases (the limit under §401(a)(17) of the Code prior to the effective date of the EGTRRA amendments to that section). B is a former participant in Plan A who retired as of December 31, 2001. As of December 31, 2001, B has 10 years of service and compensation of \$250,000 for each of the 3 years 1999, 2000, and 2001. B's high 3-year average compensation of \$166,667 is determined as the average of annual compensation (as limited by § 401(a)(17) of the Code) of \$160,000 for 1999, \$170,000 for 2000, and \$170,000 for 2001. B's annual benefit under the plan formula as of December 31,

2001, is \$16,667, calculated as $(10) \times (.01) \times (\$166,667)$. As of December 31, 2001, B is a "highly compensated former employee," as defined in §1.410(b)-9, and a "former HCE," as defined in §1.401(a)(4)-12, for purposes of applying the nondiscrimination rules under §§410(b) and 401(a)(4) respectively.

In 2002, Plan A is amended (1) to use the \$200,000 compensation limit for compensation paid in years beginning after December 31, 2001, (2) to use the \$200,000 compensation limit for compensation paid in years beginning prior to January 1, 2002, in determining benefit accruals in years beginning after December 31, 2001, and (3) to use the \$200,000 compensation limit in determining retirement benefits to be paid after December 31, 2001, to employees who retired on or before December 31, 2001. A high 3-year average compensation of \$200,000 is determined for B as of December 31, 2002, as the average of annual compensation (as limited by § 401(a)(17) of the Code, as amended by EGTRRA) of \$200,000 for 1999, \$200,000 for 2000, and \$200,000 for 2001. As of December 31, 2002, B's annual benefit under the plan formula is \$20,000, calculated as $(10) \times (.01) \times (\$200,000)$.

LAW AND ANALYSIS

Section 401(a)(17) limits the annual compensation that may be taken into account for purposes of determining a participant's benefit accruals under a defined benefit plan or a participant's allocations under a defined contribution plan. Section 401(a)(17) also limits the annual compensation that may be taken into account for purposes of certain nondiscrimination requirements, including those in §§401(a)(4), 401(a)(5), 401(l), 401(k), 401(m), 403(b)(12), 404(a)(2), and 410(b)(2), and for purposes of determining whether a definition of compensation is nondiscriminatory under §414(s)(3). Under §401(a)(17), as in effect prior to the effective date of the EGTRRA amendment, the compensation limit was \$150,000, indexed in \$10,000 increments for cost-of-living adjustments. For 2001, the compensation limit was \$170,000. A higher compensation limit applies to eligible participants in certain governmental plans. See §1.401(a)(17)-1(d)(4)(ii) of the Income Tax Regulations.

Section 611(c) of EGTRRA amended §401(a)(17) of the Code by increasing the \$150,000 limit (as adjusted) to \$200,000, and changing the method used for cost-of-living adjustments. Section 611(c) of EGTRRA made similar amendments to §§404(l), 408(k), and 505(b)(7) of the Code.

Section 611(i)(1) of EGTRRA provides that the increase in the compensation limit under §401(a)(17) of the Code applies to years beginning after December 31, 2001. Thus, for purposes of determining benefit accruals or the amount of allocations for plan years beginning on or after January 1, 2002, compensation taken into account may not exceed the compensation limit under §401(a)(17), as amended by section 611(c) of EGTRRA.

Notice 2001-56, 2001-2 C.B. 277, provides that in the case of a plan that uses annual compensation for periods prior to the first plan year beginning on or after January 1, 2002, to determine accruals or allocations for a plan year beginning on or after January 1, 2002, the plan is permitted to provide that the \$200,000 compensation limit applies to annual compensation for such prior periods in determining such accruals or allocations.

Section 1.401(a)(4)-5 provides general rules for determining whether the timing of a plan amendment has the effect of discriminating significantly in favor of highly compensated employees. Section 1.401(a)(4)-5(a) provides that whether the timing of a plan amendment has the effect of discriminating significantly in favor of HCEs or former HCEs is determined at the time the plan amendment first becomes effective for purposes of §401(a), and is based on all of the relevant facts and circumstances.

Section 1.401(a)(4)-10 provides rules for determining whether a plan satisfies the nondiscrimination requirements of §401(a)(4) with respect to benefits provided to former employees, generally in the form of a plan amendment. Section 1.401(a)(4)-10(b)(1) provides that a plan is nondiscriminatory with respect to the amount of benefits provided to former employees if, under all of the relevant facts and circumstances, the amount of benefits provided to former employees does not discriminate significantly in favor of former employees who are

highly compensated employees (HCEs). For this purpose, §1.401(a)(4)-10(b)(1) specifies that benefits provided to former employees include all benefits provided to former employees or, at the employer's option, only those benefits arising out of the amendment providing the benefits.

Section 1.410(b)-2(c) provides rules for determining whether the group of former employees benefiting under a plan for a year satisfies the coverage requirements of §410(b) with respect to former employees. Section 1.410(b)-2(c)(2) provides that a plan satisfies §410(b) with respect to former employees if, under all of the relevant facts and circumstances, a group of former employees benefiting under the plan does not discriminate significantly in favor of highly compensated former employees. Section 1.410(b)-3(b) provides that for this purpose, a former employee is treated as benefiting for a plan year if and only if the plan provides a benefit increase to the former employee for the plan year.

Based on all the relevant facts and circumstances, the amendment to Plan A satisfies the requirements of §401(a)(4) and §410(b).

HOLDING

A plan amendment to apply the increased compensation limits under section 611(c) of EGTRRA to all former employees (or all former employees who retain accrued benefits under the plan) that is effective as of the first plan year beginning after December 31, 2001, satisfies the requirements of §401(a)(4) and §410(b) of the Code.

DRAFTING INFORMATION

The principal drafters of this revenue ruling are Steven Linder of the Employee Plans, Tax Exempt and Government Entities Division and Linda Phillips of the Office of the Associate Chief Counsel/Division Counsel (TEGE). For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Linder may be reached at (202) 283-9888; Ms. Phillips may be reached at (202) 622-6090. The telephone numbers in the preceding sentence are not toll-free.