

Inclusion of Elective Reductions for Qualified Transportation Fringes in Compensation Under Qualified Plans and 403(b) Plans

Notice 2001-37

I. PURPOSE

The purpose of this notice is to provide guidance relating to the amendments made by § 314(e) of the Community Renewal Tax Relief Act of 2000 (“CRA”) to §§ 403(b)(3), 414(s)(2), and 415(c)(3) of the Internal Revenue Code. These Code sections provide definitions of compensation that apply to plans described in §§ 401(a) and 403(a) (“qualified plans”) and § 403(b) (“403(b) plans”). The CRA amendments change these compensation definitions to reflect the amount of the compensation reduction elected for qualified transportation fringes that is not includible in the employee’s gross income by reason of § 132(f)(4) of the Code (“§ 132(f) elective reductions”). The CRA amendments to §§ 403(b)(3), 414(s), and 415(c)(3) are retroactively effective for years beginning after December 31, 1997.

Specifically, this notice provides that –

- Qualified plans must be operated in accordance with the CRA amendments for plan and limitation years beginning on or after January 1, 2001. Plan amendments that are needed as a result of the CRA amendments must be adopted within the GUST remedial amendment period. The plan amendments must be effective no later than the first day of the first plan and limitation years beginning on or after January 1, 2001.
- Sponsors of qualified plans may satisfy the preceding requirements by adopting the model amendments included in the appendix to this notice.
- Qualified plans will not be disqualified solely on account of a failure to reflect in form or operation the CRA amendments to §§ 414(s) and 415(c)(3) for plan and limitation years beginning before January 1, 2001. Retroactive

plan amendments that take the CRA amendments into account for those years are required only for plans that operated in those years in accordance with §§ 414(s) and 415(c)(3) as amended.

- Exclusion allowances for employees who participate in 403(b) plans need not be recalculated under § 403(b)(2) on account of the CRA amendments for years before January 1, 2001.

II. BACKGROUND

Section 132(a)(5) of the Code provides that a qualified transportation fringe is excluded from an employee’s gross income. Section 132(f)(1) defines a qualified transportation fringe to include employer-provided transportation in a commuter highway vehicle between the employee’s home and office, transit passes, and qualified parking. Section 132(f)(4) provides that no amount is included in an employee’s gross income solely because the employer offers the employee a choice between any qualified transportation fringe and compensation that would otherwise be included in gross income.

The definition of compensation under § 415(c)(3) is used to determine whether annual additions to a participant’s account exceed the percentage limitation described in § 415(c)(1)(B). The definition is also used for other purposes under the Code relating to qualified plans, including the percentage limitation described in § 415(b)(1)(B), the determination of who is a highly compensated employee under § 414(q), and the determination of who is a key employee and the amount of required minimum contributions or benefits for top-heavy plans under § 416. Further, this definition is frequently used by qualified plans to determine employees’ benefits. Section 415(c)(3)(D) was added by the Small Business Job Protection Act of 1996 (“SBJPA”), effective for years beginning after December 31, 1997. Prior to amendment by CRA, § 415(c)(3)(D) provided that a participant’s compensation includes elective deferrals as defined in § 402(g)(3) and amounts contributed or deferred by the employer at the election of the employee that are not includible in

gross income by reason of § 125 or 457. CRA amended § 415(c)(3)(D)(ii), effective for years beginning after December 31, 1997, to provide that a participant’s compensation for any year after 1997 also includes § 132(f) elective reductions. It should be noted that, for some of the purposes for which the definition of § 415(c)(3) is used, e.g., the definition of highly compensated employee (which is required to be based on prior year compensation data), the change to the § 415(c)(3) compensation would not affect the plan until the year after the first year for which it is effective.

Section 414(s) provides a definition of compensation that applies for any Code provision that specifically refers to § 414(s). The definition of compensation under § 414(s) is used for nondiscrimination testing under qualified plans and 403(b) plans, including the actual deferral percentage (“ADP”) test under § 401(k)(3) and the actual contribution percentage (“ACP”) test under § 401(m)(2). Section 414(s)(1) provides that compensation has the meaning given in § 415(c)(3). Prior to amendment by CRA, § 414(s)(2) provided that an employer may elect not to include as compensation amounts contributed by the employer pursuant to a salary reduction agreement that are not includible in the employee’s gross income under § 125, 402(e)(3), 402(h), or 403(b). CRA amended § 414(s)(2), effective for years beginning after December 31, 1997, to add § 132(f) elective reductions to this list. Section 414(s)(3) requires the Secretary of the Treasury to provide for alternative definitions of compensation that satisfy § 414(s) and that do not discriminate in favor of highly compensated employees.

Section 1.414(s)-1(c)(1) prescribes general rules regarding the definition of compensation under § 414(s). Section 1.414(s)-1(c)(2) provides that a definition of compensation that includes all compensation under § 415(c)(3), as described in § 1.415-2(d), and excludes all other compensation, is a safe harbor definition of compensation for purposes of § 414(s). Prior to the amendment of § 415(c)(3) by SBJPA, total compensation under § 415(c)(3) did not include elective

amounts. Section 1.414(s)–1(c)(4) provides that a definition of compensation that includes all compensation under § 415(c)(3) and also includes elective amounts that are not includible in gross income under §§ 125, 402(e)(3), 401(h), and 403(b), compensation deferred under an eligible deferred compensation plan described in § 457(b), and employee contributions described in § 414(h)(2) that are picked up by the employer, is a safe harbor definition of compensation for purposes of § 414(s). Section 1.414(s)–1(c)(1) and (4) does not reflect the amendments to § 415(c)(3) by SBIPA and CRA. A definition of compensation that does not satisfy one of the safe harbors can nonetheless satisfy § 414(s) if it satisfies the nondiscrimination requirement of § 1.414(s)–1(d).

Section 403(b)(3) provides a definition of “includible compensation” that is used for purposes of determining an employee’s exclusion allowance under § 403(b)(2). The Taxpayer Relief Act of 1997 (“TRA ’97”) amended the definition of includible compensation under § 403(b)(3) to include elective deferrals as defined in § 402(g)(3) and amounts contributed or deferred by the employer at the election of the employee that are not currently includible in gross income by reason of § 125 or 457, effective for years beginning after December 31, 1997. CRA amended § 403(b)(3)(B), effective for years beginning after December 31, 1997, to provide that includible compensation for any year after 1997 also includes § 132(f) elective reductions. For employees who make the election under § 415(c)(4)(D) to have the provisions of § 415(c)(4)(C) apply, the exclusion allowance under § 403(b)(2) is determined with reference to the limitations under § 415. In this case, the definition of compensation under § 415(c)(3) applies.

Section 1.401(b)–1(b)(3) authorizes the Commissioner to designate a plan provision as a disqualifying provision if the provision either (1) results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in those requirements or (2) is integral to a qualification requirement that has been changed. The remedial amendment period for a disqualifying provision that is integral to a qualification requirement that has been changed begins on the

first day on which the plan was operated in accordance with such provision, as amended (unless another time is specified by the Commissioner). Section 1.401(b)–1(c)(3) authorizes the Commissioner, in the case of disqualifying provisions designated as described in the preceding sentence, to impose limits and provide additional rules regarding the amendments that may be made with respect to that disqualifying provision.

Revenue Procedure 2000–27, 2000–26 I.R.B. 1272, provides that the GUST remedial amendment period for nongovernmental plans ends on the last day of the first plan year beginning on or after January 1, 2001. The remedial amendment period for governmental plans, as defined in § 414(d), ends on the later of (i) the last day of the first plan year beginning on or after January 1, 2001, or (ii) the last day of the first plan year beginning on or after the “2000 legislative date” (that is, the 90th day after the opening of the first legislative session beginning after December 31, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously). An extended GUST remedial amendment period may be available under the provisions of Rev. Proc. 2000–20, 2000–6 I.R.B. 553. The GUST remedial amendment period is available for certain plan amendments, including amendments to comply with the Uruguay Round Agreements Act, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, and the Internal Revenue Service Restructuring and Reform Act of 1998.

III. APPLICATION OF THE CRA AMENDMENTS TO §§ 414(s) AND 415(c)(3) TO QUALIFIED PLANS

The CRA amendments not only change the definitions of compensation under §§ 414(s) and 415(c) but also, as described above, affect other qualification requirements that depend in part on those Code sections. Pursuant to § 1.401(b)–1(b)(3), plan provisions that must be amended as a result of the CRA amendments and plan provisions that are integrally related to qualification requirements changed by the CRA amendments are hereby designated disqualifying provisions, as further described below. Pur-

suant to the authority under § 1.401(b)–1(c)(3), the remedial amendment period with respect to such disqualifying provisions ends on the last day of a plan’s GUST remedial amendment period.

A. Prospective application

For plan and limitation years beginning on or after January 1, 2001, a plan provision is a disqualifying provision if it causes the plan to fail to satisfy the qualification requirements as a result of the CRA amendments for such years. Accordingly, a plan must be amended within the plan’s GUST remedial amendment period to the extent necessary to comply in form with the CRA amendments for plan and limitation years beginning on or after January 1, 2001. The plan must also be operated in accordance with the CRA amendments for those years.

B. Retroactive application

Pursuant to § 7805(b), the Service will not treat a qualified plan as having failed to satisfy the requirements of § 401(a) merely because the plan did not take the CRA amendments into account for plan or limitation years beginning before January 1, 2001.

For plan and limitation years beginning on or after January 1, 1998, a plan provision is a disqualifying provision if the plan provision is integral to a qualification requirement changed by the CRA amendments. Thus, plans that took the CRA amendments into account in operation for plan or limitation years beginning before January 1, 2001, must be retroactively amended within the GUST remedial amendment period to the extent necessary to comply in form with the CRA amendments. The plan amendments must be effective retroactively to the first day of the plan and limitation years for which the plan was first operated in accordance with the CRA amendments. Under this notice, retroactive plan amendments that take into account the CRA amendments for plan and limitation years beginning before January 1, 2001, are required only for those plans that took the CRA amendments into account in operation for those years. A plan that has not been operated in accordance with the CRA amendments for plan or limitation years beginning before January 1, 2001, may not be amended retroactively for CRA, but must be amended for

years beginning on or after January 1, 2001, as described in § IIIA above.

C. Examples

The following examples illustrate the application of the CRA amendment to § 415(c)(3) to qualified plans. The examples assume, in each case, that the employers provide for § 132(f) elective reductions.

Example 1. Employer A sponsors a calendar year defined benefit plan that specifically includes amounts deferred under §§ 125, 402(g)(3), and 457, but not § 132(f) elective reductions, in the definition of compensation for purposes of applying the § 415(b) limitations, the definition of key employee under § 416, and calculating the § 416 top-heavy minimums. Because the plan's definition of compensation is used for purposes of the plan's provisions relating to §§ 415 and 416, the plan must be operated and amended, effective January 1, 2001, by the end of its GUST remedial amendment period, to reflect § 415(c)(3) as amended by CRA.

Example 2. Employer B sponsors a money purchase pension plan that includes a definition of compensation for making contributions that specifically includes amounts deferred under §§ 125, 402(g)(3), and 457, but not § 132(f) elective reductions, in the definition of compensation for purposes of applying the § 415(c) limitations, the definition of key employee under § 416, and calculating the § 416 top-heavy minimums. The plan year and limitation year both begin on October 1. However, for plan and limitation years beginning on October 1, 1999, the plan administrator operated the plan to include § 132(f) elective reductions. Employer B must amend the plan's definition of compensation to include § 132(f) elective reductions. The amendment must be made effective retroactively for plan and limitation years beginning on October 1, 1999, and must be adopted by the end of the plan's GUST remedial amendment period.

IV. 403(b) PLANS

CRA amended § 403(b)(3) to provide that, for purposes of determining the exclusion allowance under § 403(b)(2), § 132(f) elective reductions are to be included in an employee's compensation for years beginning after December 31, 1997. For the 2001 and later taxable years, employees' exclusion allowances are calculated taking into account the CRA amendment of § 403(b)(3). For purposes of determining the exclusion allowance for employees for 1998 and years thereafter to the extent the determination uses compensation with respect to 1998, 1999, and 2000, compensation may be calculated in

accordance with § 403(b) as it read after amendment by TRA '97 but before amendment by CRA, i.e., by not including § 132(f) elective reductions in the definition of compensation.

A 403(b) plan that is required to satisfy the nondiscrimination requirements of § 403(b)(12) must be operated in accordance with the CRA amendments to §§ 403(b), 414(s), and 415(c) in years beginning on or after January 1, 2001.

V. PROCEDURES RELATING TO ADOPTION OF MODEL AMENDMENTS

The model amendments that appear in the Appendix to this revenue procedure may be adopted by sponsors of individually designed plans (including adopters of volume submitter plans) and by practitioners that sponsor volume submitter specimen plans. The model amendments may also be used by sponsors and adopters of master and prototype (M&P) plans.

The model amendments in the appendix to this revenue procedure, if adopted on a word-for-word identical basis within a plan's GUST remedial amendment period, will be deemed to satisfy the requirements of §§ 415(c)(3) and 414(s)(2) as amended by CRA, respectively. Practitioners that sponsor volume submitter specimen plans may include the model amendments in a specimen plan without adversely affecting the plan's advisory letter. An employer that has adopted a volume submitter specimen plan prior to this amendment of the specimen plan may individually adopt the model amendments without adversely affecting the plan's determination letter. Sponsors of M&P plans that have not yet been approved for GUST may incorporate the model provisions in adoption agreements. Sponsors of M&P plans that have been approved for GUST may provide the model amendments to adopting employers as supplements to the approved adoption agreement. The Service will not issue new opinion, advisory, or determination letters for plans that are amended solely to add the model amendments.

M&P and volume submitter plan sponsors that use the model language must file Form 8837, *Notice of Adoption of Rev-*

enue Procedure Model Amendments. At line 2 of Form 8837, enter "Notice 2001-37" instead of "Revenue Procedure."

DRAFTING INFORMATION

The principal drafter of this revenue procedure is Diane S. Bloom of the Employee Plans Division. For further information regarding this revenue procedure, please contact the Employee Plans Division's taxpayer assistance telephone service at (202) 283-9516 or (202) 283-9517, between the hours of 1:30 p.m. and 3:30 p.m. Eastern Time, Monday through Thursday. Ms. Bloom may be reached at (202) 283-9888. These telephone numbers are not toll-free.

APPENDIX — MODEL AMENDMENTS

The following are model amendments that sponsors of qualified plans may adopt to comply with §§ 415(c) and 414(s), as amended by CRA. Plan sponsors should first review their plan documents and operation to determine whether the plan already complies with §§ 415(c) and 414(s), as amended.

A. Model language for § 415(c)(3) compensation definition

For limitation years beginning on and after [enter the earlier of January 1, 2001, or the first day of the first limitation year for which the plan was operated in accordance with the CRA amendment of § 415(c)(3), but in no case earlier than the first day of the first limitation year beginning on or after January 1, 1998], for purposes of applying the limitations described in section ____ of the plan, compensation paid or made available during such limitation years shall include elective amounts that are not includible in the gross income of the employee by reason of § 132(f)(4).

(Note: The following language may be adopted for plans that also use § 415(c)(3) compensation for other purposes under the plan.)

This amendment shall also apply to the definition of compensation for purposes of section(s) ____ of the plan for plan years beginning on and after

[enter the earlier of January 1, 2001, or the first day of the first plan year for which these sections of the plan were operated in accordance with the CRA amendment of § 415(c)(3), but in no case earlier than the first day of the first plan year beginning on or after January 1, 1998].

B. Model language for § 414(s) compensation definition that excludes amounts of compensation reduction elected for qualified transportation fringes

(Note: The following language should be adopted only for a plan that either 1)

has been operated since the first day of the first plan year beginning on or after January 1, 1998 (or any subsequent plan year beginning before January 1, 2001), or 2) has been operated since the first day of the first plan year beginning on or after January 1, 2001, by excluding from its definition of compensation under § 414(s) any amount that is contributed by the employer pursuant to a salary reduction agreement and that is not includible in the employee's gross income under § 125, 132(f), 402(e)(3), 402(h), or 403(b).

For plan years beginning on and after [enter the earlier of January 1, 2001, or

the first day of the first plan year for which the plan was operated in accordance with the CRA amendment of § 414(s), but in no case earlier than the first day of the first plan year beginning on or after January 1, 1998], compensation shall not include elective amounts that are not includible in the gross income of the employee under § 125, 132(f)(4), 402(e)(3), 402(h), or 403(b). This amendment shall apply for purposes of section(s) _____ of the plan.