

FBA

News Notes



News and Information on Employee Benefit Plans

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The Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836) (05/31/01)

Major Pension & Benefits Changes Under New Tax Act
The "Economic Growth And Tax Relief Reconciliation Act of 2001" (EGTRRA), signed into law June 7, 2001 by President Bush, made many sweeping changes to the tax laws. In addition to lowering marginal tax rates, repealing the estate tax, and making many other important tax law changes, the bill made very significant modifications to the rules affecting qualified plans and IRAs. This new law will require plan sponsors to reevaluate their overall approach to retirement benefits. These retirement law amendments are particularly noteworthy because most take effect on January 1, 2002, unlike many other tax law changes in EGTRRA that have delayed effective dates.

Key Pension And Benefit Changes Include:

- Increased Contribution and Benefit Limits
- "Catch Up" Contribution for Participants over Age 50
- Increased Maximum Compensation Limits
- Enhanced Deduction Limits
- Increased Portability between most Plans
- Accelerated Vesting on Matching Contributions
- Modification of Top-Heavy Rules
- Incentives for Small Businesses to Establish New Retirement Plans
- Repeal and Simplification of many Administrative Rules

What follows is a summary highlighting the most significant Qualified Plan and IRA Plan changes:

Increased Contribution And Benefit Limits

The following provisions regarding contributions and benefits are generally effective for taxable years **beginning on or after January 1, 2002,**

- **Maximum Compensation Limitation** - The limit on compensation that may be taken into account under a qualified plan increases to \$200,000, in 2002 (currently \$170,000). Future increases will be indexed to inflation in \$5,000 increments. (Act Section 611 amending IRC Section 401(a)(17))
- **Limit On Annual Additions To Defined Contribution Plans** - The dollar limit on annual additions to a Defined Contribution plan increases from \$35,000 to \$40,000 in 2002. This amount will be indexed for inflation in \$1,000 increments. In addition the related compensation limit for annual additions is increased to 100% of compensation from 25%. (Act Section 611 amending IRC Section 415(c))
- **Limit On Annual Benefits For Defined Benefit Plans** - The annual benefit limit under a Defined Benefit plan is increased from \$140,000 to \$160,000, in 2002. The dollar limit is actuarially reduced for benefit commencement before age 62 and increased for benefit commencement

after age 65. The dollar limit will continue to be indexed to inflation. (Act Section 611 amending IRC Section 415(b))

- **Elective Deferral Limits Increased** - The dollar limit on annual elective deferrals to 401(k), 403(b), 457, and SARSEP plans is increased to \$11,000 in 2002. In 2003 and thereafter, the limits are increased in \$1,000 annual increments until the limits reach \$15,000 in 2006, with indexing in \$500 increments thereafter. (Act Section 611 amending IRC Section 402(g))
- **Additional Salary Deferral "Catch-up" Contributions** - The Act permits participants who are age 50 or older to make additional elective deferrals above the otherwise applicable dollar limits on elective deferrals for 401(k), 403(b), SARSEP, SIMPLE or 457 plans. These additional deferrals are described as "catch-up contributions," although they are not contingent on a participant's prior level of deferrals. Beginning in 2002, the annual limit on catch-up contributions is \$1,000. This limit will increase in \$1,000 increments until it reaches \$5,000 in 2006. Thereafter, the limit on catch-up contributions will be indexed for inflation in \$500 increments.

An individual's catch-up contribution for a year may not exceed the difference between the individual's compensation for the year and the other elective deferral contributions made by the individual for the year. Catch-up contributions generally are not subject to other compensation limitations and are not taken into account for nondiscrimination testing purposes.

Also, employers may make matching contributions relating to catch-up contributions, but these matching contributions will be subject to other limitations including the nondiscrimination rules. (Act Section 631 adding IRC Section 414(v))

Dollar Amount For Catch-up Contributions Under 401(k), 403(b), SARSEP or 457 Plans:

Taxable years beginning in:	The applicable dollar amount:
2002	\$1,000
2003	\$2,000
2004	\$3,000
2005	\$4,000
2006 and thereafter	\$5,000

- **Increased IRA Contribution Limits** - The maximum annual contribution that may be made to any combination of Traditional and Roth IRAs will gradually increase as follows: (i) for 2002 through 2004, from \$2,000 to \$3,000; (ii) for 2005 to 2007, to \$4,000; and (iii) for 2008 to \$5,000. After 2008, the limit is adjusted annually for inflation in \$500 increments. (Act Section 601 amending IRC Section 219(b))
- **Additional IRA Catch-Up Contributions** - Effective for taxable years beginning on or after January 1, 2002, individuals age 50 or older by the end of the taxable year for which a contribution is made will be permitted to make additional catch-up contributions - an additional \$500 per year beginning in 2002 and an additional \$1,000 per year beginning in 2006. Unlike catch-up contributions to 401(k) plans, 403(b) plans, 457 plans, SEP-IRAs and SIMPLE IRAs, (i) an individual's maximum Traditional and Roth IRA catch-up contribution for a year is not limited by the individual's compensation and other retirement-related contributions; and (ii) the catch-up Traditional and Roth IRA is not indexed to inflation. (Act Section 601 amending IRC Section 219(b))
- **Contribution Limits Under SIMPLE 401(k) Plans** - The maximum annual elective deferral that may be made to a SIMPLE plan is increased to \$7,000 in 2002. In 2003 and thereafter, the SIMPLE plan deferral limit is increased in \$1,000 annual increments until the limit reaches \$10,000 in 2005. Beginning after 2005, the \$10,000 dollar limit is indexed for inflation in \$500 increments. Individuals age 50 or older by the end of the tax year for which an elective deferral contribution to a SIMPLE IRA is made will be permitted to make additional catch-up contributions. The catch-up contribution will be phased in gradually and will ultimately be \$2,500 by 2006. After 2006, the \$2,500 catch-up contribution will be indexed to inflation in \$500 increments. (Act Section 611 amending IRC Section 402(g))
- **Contribution Limits Under 403(b) Plans** - The Act eliminates the maximum exclusion allowance applicable to contributions to 403(b) plans and replaces it with the Section 415 limits on annual additions. The limit on annual additions that can be made to a Section 403(b) plan on behalf of employees is the lesser of \$40,000 (adjusted for inflation) or 100% of the employee's compensation. As discussed above, the limit on elective deferrals to a 403(b) plan will be increased incrementally to \$15,000 in 2006 and eligible participants who have attained age 50 may make additional catch-up contributions. (Act Section 632 amending IRC Section 403(b)(2))
- **Contribution Limits Under 457 Plans** - The dollar limit on deferrals under an eligible 457 plan is increased to conform to the elective deferral limitation. Thus, the limit is \$11,000 in 2002, and is increased incrementally to \$15,000 in 2006. However, in the three years prior to retirement, the catch-up contribution rule does not apply to a 457 plan, but the otherwise applicable limit (for individuals less than age 50) is doubled. The maximum percentage limit on deferrals to an eligible 457 plan is increased to 100% from 33-1/3%. (Act Section 632 amending IRC Section 457(b)) Additionally, the rules coordinating the 457-dollar limit with contributions under 401(k), 403(b), SARSEP and SIMPLE plans is repealed. (Act Section 615 amending IRC Section 457(c))

Increased Deduction Limits

Currently, employers sponsoring a profit sharing or 401(k) plan generally may deduct an amount equal to 15% of total compensation of plan participants for the year. "Compensation" for this purpose generally does not include salary reduction amounts, although such amounts are included in the contribution subject to the limits. The following changes are effective for taxable years beginning on or after January 1, 2002.

- **Annual Limit Increased To 25% Of Compensation** - For the annual limitation on the amount of deductible contributions to defined contribution plans (including money purchase plans), the deduction limit is raised to 25% of the total compensation of plan participants for the plan year. (Act Section 616 amending IRC Section 404(a)(3))
- **Elective Deferrals Not Counted Against Deduction Limits** - Under current law, employee elective deferrals to a 401(k) plan are treated as employer contributions and thus, are subject to the generally applicable deduction limits. The Act provides that elective deferral contributions will not be subject to the deduction limits of Section 404 and will be deductible in addition to the employer contribution. Thus, the 25% limit on deductions will only apply to matching and other nonelective contributions made by the employer to the plan.

Consequently, subject to other limitations on employer and employee contributions, an employer may permit employees to defer up to 100% of their compensation and can fully deduct such employee elective deferrals, while also taking a deduction for any additional employer contributions to the plan up to 25% of the total participant compensation for the plan year. (Act Section 614 adding new IRC Section 404(n))
- **Elective Deferrals Counted As Compensation For Purposes Of Deduction Limits** - The definition of "compensation" for purposes of Section 404 is expanded to include salary reduction amounts. (Act Section 616 amending IRC Section 404(a))

Rollover And Direct Transfer Rules

- **Expanded Rollovers** - Currently, distributions from a tax-qualified defined benefit or defined contribution plan that otherwise meet the definition of an "eligible rollover distribution" can be rolled over only to an IRA or another qualified plan. They cannot be rolled over to a 403(b) plan or a 457 plan. Similarly, distributions from these other types of plans cannot be rolled over to a tax-qualified plan. Also, surviving spouses generally may only roll over a distribution to an IRA. The Act removes these rollover restrictions and generally allows an eligible rollover distribution from any of the above plans to be rolled over to another type of plan. However, a plan is not required to accept such rollovers. Distributions for which capital gains or averaging treatment are available and sought may only be rolled over in accordance with existing rollover rules. (Act Section 641 amending IRC Sections 402(c)(8), 403(b)(8), and 457(e))
- **Rollover Of After-Tax Contributions** - Employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA, so long as the qualified plan provides separate accounting for such contributions. However, after-tax contributions (including nondeductible IRA contributions) may not be rolled over from an IRA to a qualified 401(a) plan, 403(b), or 457 plan. Rollovers of after-tax contributions from one qualified plan to another qualified plan are permitted only through direct rollovers. (Act Section 643 amending IRC Section 402(c))
- **Sixty-Day Rollover Requirement** - The Act revises the requirement that a participant must roll over a distribution within 60 days after the distribution by giving the IRS authority to waive the 60-day requirement in cases of casualty, disaster, or other events beyond the control of the participant.
- **Expansion Of Spousal Rollovers** - The Act also permits a surviving spouse to roll over distributions not only to an IRA, but also to a qualified retirement plan, 403(b), or 457 plan in which he or she participates. (Act Section 641 amending IRC Section 402(c)(9))

Additional 401(k) Changes

- **401(k) & 401(m) Multiple Use Test Repealed** - The multiple use test for 401(k) and 401(m) plans is repealed for plan years beginning on or after January 1, 2002. The multiple use test generally has been viewed as adding an unnecessary level of complexity to an already unwieldy testing scheme. (Act Section 666 amending IRC Section 401(m)(9))
- **Repeal Of "Same Desk" Rule** - Currently, distributions from 401(k) plans are permitted only in the event of the participant's attainment of age 59½, death, disability, or "separation from service." Under the so-called "same desk" rule, "separation from service" occurs only upon death, retirement, resignation, or discharge, and not when an employee continues service at the same job for a different employer, as the result of a merger or liquidation.

The Act effectively eliminates the "same desk" rule by providing that distributions may be made upon a participant's "severance from employment" rather than a "separation from service."

Also, the Act does not change the rule that no distribution is allowed if plan assets and liabilities relating to an employee's benefit are transferred to the employee's new employer as part of the corporate transaction. The elimination of the "same desk" rule is effective for distributions occurring on or after January 1, 2002, regardless of when the severance from employment occurred. This change should significantly simplify the treatment of 401(k) plans in corporate mergers and acquisitions. (Act Section 646 amending IRC Section 401(k))
- **Modification To Hardship Distribution Rules** - For plans using the IRS's safe harbor hardship rules to determine immediate and heavy financial need, the Act requires the IRS to revise its regulations so that the prohibition on elective deferrals after a hardship distribution will be limited to only 6 months (currently 12 months). This revision must be effective for distributions on or after January 1, 2002. The Act also clarifies that any distribution designated by a defined contribution plan as a hardship distribution - even if the distribution is not subject to the 401(k) hardship distribution standards - is not an eligible rollover distribution. (Act Section 636 amending Treas. Reg. Sect. 1.401(k)-1(d))
- **Faster Vesting Of Employer Matching Contributions** - One of the most significant changes in the law is that employers will have to accelerate the time it takes for matching contributions to vest. Under current law, a plan must vest a participant's matching contributions using either a 5-year "cliff" vesting schedule or a 3-to-7 year "graded" vesting schedule. Effective for contributions for plan years beginning on or after January 1, 2002, a plan must now use either a 3-year "cliff" vesting schedule or a 2-to-6 year "graded" vesting schedule (with 20% annual increments). While those are the maximum limits, federal law gives employers discretion to shorten them. (Act Section 633 amending IRC Section 411(a))
- **Deemed IRAs Under Employer Plans** - Effective for plan years beginning after December 31, 2002, if a 401(a), 403(b), or 457 plan permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs, then the separate account or annuity is deemed a traditional IRA or a Roth IRA, as applicable, for all purposes of the IRC. The deemed IRA, and contributions thereto, are not subject to the IRC rules pertaining to the eligible retirement plan. In addition, the deemed IRA, and contributions thereto, are not taken into account in applying such rules to any other contributions under the plan. The deemed IRA is subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to the plan. (Act Section 602 amending IRC Section 408)
- **Option To Treat Elective Deferrals As Roth Contributions** - Currently, 401(k) plans may allow employees to make both pre-tax salary deferrals and after-tax salary deferrals. While the pre-tax deferrals have the benefit of deferring current taxes on the deferred amount and any earnings until they are distributed, the only benefit of the after-tax contributions is to defer tax on any earnings until distribution. The Act permits (but does

not require) employers to allow employees to make after-tax deferrals to 401(k) plans that will function in a similar manner to Roth IRA contributions, meaning neither the deferrals nor the earnings will be subject to federal income taxes when they are distributed. These after-tax deferrals will be known as Roth 401(k) contributions. However, the Roth 401(k) contribution provisions will not be effective until 2006, which gives Congress plenty of time to repeal or alter what could be a significant tax-savings opportunity. (Act Section 617 adding new IRC Section 402A)

Top Heavy Rules, Effective In 2002

The following provisions with respect to the "Top-Heavy" Plan rules are effective for taxable years **beginning after December 31, 2001**.

- **Definition Of Key Employee Simplified** - Under the Act, key employees will include only (i) officers earning over \$130,000; (ii) five-percent owners; and (iii) one-percent owners earning over \$150,000. The Act increases the compensation threshold for officers and eliminates the "top-ten owner" rule. In addition, key employees will include only those employees who fall under one of the above categories in the preceding plan year, rather than over the last five years. Family attribution of ownership interests will continue to apply only to the determination of employees who are five-percent owners.
- **Determining Top-Heavy Status** - Under the Act, the determination of the benefits included in the top-heavy calculation is modified. The calculation of whether the plan is top-heavy generally will take into account only current benefits and distributions made in the one-year period ending on the date the top-heavy determination is being made, instead of including distributions to key employees in the past five years. However, in-service distributions made in the past five years will continue to be included in the top-heavy calculation. Further, benefits attributable to former employees will not be taken into account if the employee has performed no services for the employer in the one-year period ending on the top-heavy determination date.
- **Safe Harbor 401(k) Plan Is Non Top-Heavy** - The Act provides that a 401(k) plan meeting the safe harbor nondiscrimination requirements of Section 401(k)(12) of the IRC will automatically avoid top-heavy status. The safe harbor under Section 410(k)(12) generally requires that an employer make either (i) a nonelective contribution of 3% of compensation; or (ii) a matching contribution equal to 100% of salary deferrals up to 3% of compensation, plus 50% of deferrals from 3% to 5% of compensation. The top-heavy exemptions for safe harbor 401(k) plans should increase the appeal of safe harbor plans.
- **Matching Contributions Applied To Top-Heavy Minimum Contribution** - Matching contributions may now be taken into account with respect to each non-key employee for purposes of satisfying the minimum top-heavy contribution requirement of Section 416(c)(2)(A). (Act Section 613 amending IRC Section 416)
- **"Frozen" Defined Benefit Plans** - For purposes of the minimum benefit requirements under Section 416(c)(1), a year of service does not include any year in which no key employee or former key employee benefits under the plan (as determined under Section 410(b)). Therefore "frozen" Defined Benefit plans will not be required to provide minimum accruals for non-key employees. (Act Section 613 amending IRC Section 416)

Incentives For Small Businesses To Establish New Retirement Plans

- **New Plan Tax Credit** - The Act gives certain small employers a general business tax credit equal to 50% of the employer's administrative and retirement-education expenses incurred in the first 3 years following the adoption of a qualified benefit or defined contribution plan, or a SIMPLE 401(k) plan. For purposes of the credit, a small employer means an employer with no more than 100 employees who earned \$5,000 or more in the preceding year and at least one non-highly compensated employee. The maximum credit in any one year is equal to \$500. The 50% of expenses offset by the credit are not deductible by the employer. The

credit is effective for costs paid or incurred in the 3 taxable years beginning after December 31, 2001 by a plan established after that date. (Act Section 619 adding new IRC Section 45E)

- **Elimination Of IRS User Fees** - Effective in 2002, the Act eliminates IRS user fees for determination letter requests by small employers as long as the request is submitted before the later of (i) the fifth plan year after adoption of the plan, or (ii) the end of the applicable remedial amendment period for the plan that begins before the fifth year of the plan. For purposes of this provision, a small employer is any employer with no more than 100 employees and at least one non-highly compensated employee. The provision is not applicable to sponsors of prototype plans seeking IRS notification or opinion letters, but does apply to employers who adopt prototype plans. (Act Section 620)

Other Notable Changes

- **Plan Loans To Owner-Employees** - Generally, a loan from a qualified plan to an "owner-employee" is a prohibited transaction. Effective for years beginning after December 31, 2001, a loan from a qualified plan to a sole proprietor, 10% or more partner or 5% or more S corporation shareholder is exempt from the prohibited transaction rules. However, loans from a qualified plan continue to be prohibited to an owner of an IRA. (Act Section 612 amending to IRC Section 4975(f)(6))
- **Involuntary Cash-Out Rules** - A qualified plan currently is permitted to distribute a terminated employee's plan benefit without the employee's consent if the present value of the benefit does not exceed \$5,000. The Act allows a plan to disregard amounts that have been rolled over to the plan in calculating whether the employee's benefit exceeds \$5,000. (Act Section 648 amending IRC Section 411(a)(11))
- **Automatic IRA Rollover** - To discourage early cash-outs, the Act requires that, for involuntary cash-out distributions exceeding \$1,000, the default option is a direct rollover to an employer-established IRA. Of course, the employee still has the option of designating an IRA or other employer plan to receive the distribution or taking a cash distribution. The new rules allow employers to roll balances of \$1,000 to \$4,999 into a default IRA. This rule wouldn't apply to balances under \$1,000. The DOL is to issue regulations (within three years) allowing for safe harbor IRA investments that will satisfy the fiduciary duty rules of ERISA, and thereby relieve plan officials from any further responsibility. These mandatory IRA rollovers will only be required after the DOL has adopted final regulations.
- **Limitation On Anti-Cutback Rules** - Until recently, no qualified plan could adopt an amendment that reduced or eliminated "protected benefits," which are generally defined as accrued benefit, including an early retirement benefit or retirement-type subsidy, or any optional form of benefit, such as an annuity or installment form of distribution. The IRS recently issued regulations permitting the elimination of certain forms of distribution in most defined contribution plans, following notice to participants, as long as the plan retains a lump sum form of distribution that is equivalent in value to the other forms of distribution. The Act largely parrots the new IRS regulations.
- **Non-Refundable Tax Credit For Employee Contributions And IRA Contributions** - Effective for taxable years beginning on or after January 1, 2002 and before January 1, 2007, a temporary nonrefundable tax credit will be provided to certain eligible individuals, of up to 50% of the tax payer's first \$2,000 of retirement savings contributions. Only joint filers with adjusted gross income of \$50,000 or less, head of household filers of \$37,500 or less, and single filers of \$25,000 or less are eligible for the credit. The credit is available with respect to elective contributions to a 401(k) plan, a 403(b) plan, a 457 plan, a SIMPLE IRA or a SEP-IRA, and with respect to contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a qualified retirement plan. (Act Section 618 adding IRC Section 25B)

- **Modifications To Education IRAs** - The Act increases the annual aggregate contribution limit to education IRAs from \$500 to \$2,000. The phase-out range for married taxpayers filing a joint return was also increased to \$190,000 to \$220,000 of adjusted gross income, twice the range for single taxpayers.

The definition of qualified education expenses has been expanded to include "qualified elementary and secondary school expenses." This includes expenses for tuition, fees, academic tutoring, special needs services, books, supplies, room and board, uniforms, transportation, and other equipment expenses incurred as part of enrollment at a public, private or religious school that provides education from kindergarten through the 12th grade. Supplementary services, such as extended day programs, that are required or provided by the school in connection with the beneficiary's enrollment are also considered qualified expenses. The definition also includes the purchase of any computer technology, equipment, or Internet access that is used by the beneficiary and his/her family while he/she is in school. Software must be educational in nature to be a qualified expense. Regardless of income, corporations and other entities are allowed to make contributions to Education IRAs. Individuals who contribute to an education IRA may make a contribution for a year until April 15 of the following year. (Act Section 401 amending IRC Section 530)

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