

ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made the most comprehensive changes in pension laws since the Employee Retirement Income Security Act (ERISA) was passed twenty-eight years ago. EGTRRA subsequently was modified by certain, primarily technical revisions that were incorporated in the Job Creation and Workers Assistance Act of 2002.

The chart which follows summarizes the changes that perhaps most affect qualified retirement plans. Several common themes are present throughout the technical changes, including: promoting greater retirement savings, increasing portability among plans, enhancing and simplifying distribution provisions, and harmonizing the various different rules applicable to different types of plans. On the one hand, these changes continue recent trends (for example, allowing loans to owner-employees continues to eliminate distinctions applicable to Keogh plans), and on the other hand the changes reflect new thinking in Washington (for example, increased contribution and benefit limits recognizes for the first time the reality that these plans often only make sense for small businesses if the owners themselves obtain some meaningful personal benefit from the program).

As with prior changes in the pension rules, some of the provisions present new risks (for example, applying the catch-up provisions), other changes present opportunities (for example, defined benefit plans), and yet other changes simply make us scratch our heads (for example, the significant yet subtle differences between government § 457(b) plans versus tax-exempt § 457(b) plans).





All-in-all, the benefits community perhaps will view these changes to be beneficial. Some exasperated practitioners, however, might question that conclusion, on the basis that the law is already obtuse enough; any enhancements, although perhaps beneficial, just add to the unending complexity without truly improving our pension system. I will leave that philosophical discussion to other folks and instead hope that the chart that follows assists you in navigating through the new rules.



Employee Benefit Provisions Affected by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) *as modified by* *The Job Creation and Workers Assistance Act of 2002 (JCWAA)*

<i>Provision and Key EGTRRA Change</i>	<i>Explanation and Prior Law</i>	<i>New Law</i>	<i>Comments</i>
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A. INCREASED CONTRIBUTION AND BENEFITS LIMITS


1.	<p>Compensation limit for qualified plans and SEPs</p> <p> <i>The compensation plans may consider increases from \$170,000 to \$200,000</i></p>	<p>The law limits the amount of compensation that may be used to determine benefits, to test for discrimination and for deductibility. The current limit is \$170,000, as adjusted for inflation in \$10,000 increments.</p>	<p>The \$170,000 limit is increased to \$200,000. Limit will be adjusted for inflation in \$5,000 increments. Effective for years beginning after Dec. 31, 2001.</p>	<p>Employers are not required to make this change, although most will and should. This might increase required funding or benefits for higher paid, and/or decrease benefits for lower paid. Will also make ADP/ACP/401(a)(4) testing easier to pass.</p>
2.	<p>401(k) contribution and other elective deferral limit</p> <p> <i>Allowable 401(k) and 403(b) employee contributions increase gradually beginning in 2002</i></p>	<p>The law limits the amount employees may contribute on a before-tax basis to 401(k) and 403(b) plans. The limit is \$10,500 in 2001.</p>	<p>Limit increases over a period of years, as follows: 2002- \$11,000 2003- \$12,000 2004- \$13,000 2005- \$14,000 2006- \$15,000, which will be adjusted for inflation after 2006. Also see A.5. below.</p>	<p>The new limit applies to highly compensated and nonhighly compensated employees alike. However, HCE deferrals are still limited by NHCE deferrals for most plans.</p>
3.	<p>SIMPLE IRA or 401(k) plan limit (these designs are only available to small employers)</p> <p> <i>Employee SIMPLE contributions increase gradually beginning in 2002</i></p>	<p>In 2001, the maximum before-tax employee contribution is \$6,500.</p>	<p>Limit increases over a period of years, as follows: 2002- \$7,000 2003- \$8,000 2004- \$9,000 2005- \$10,000, which will be adjusted thereafter for inflation.</p>	<p>SIMPLE plans sometimes make sense for small employers; this increase makes them a bit more attractive. The limit is not as high as with 401(k)s.</p>

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<p>4. 457 (tax-exempt and governmental) plan limits</p> <p> <i>The 457 employee deferral limit is the same as the 401(k) limit, with certain exceptions</i></p>	<p>For 2001, 457(b) plans limit the additions to employee's accounts to lesser of \$8,500 or 33 1/3% of includable compensation. Amounts the employee contributes under a 401(k) or 403(b) plan count against this limit.</p>	<p>Limit is now the lesser of a higher dollar amount or 100% of compensation. The dollar amounts are as follows: 2002- \$11,000 2003- \$12,000 2004- \$13,000 2005- \$14,000 2006- \$15,000, which will be adjusted for inflation after 2006. Amounts deferred under a 401(k) or 403(b) plan no longer count against the 457 limit. Effective for years beginning after Dec. 31, 2001.</p>	<p>The same limit now applies to 401(k), 403(b) and 457 plans. But, however, several differences remain. For example, the 457 limit applies to employee <i>and</i> employer contributions, and 457 plans are not subject to nondiscrimination testing. The change from 25% to 100% is a significant increase. An employee might be able to fully contribute to a 457 and 401(k) plan.</p>
<p>5. Catch-up elective deferrals for individuals 50 and older</p> <p> <i>For plans that permit employee contributions, age 50 and older participants may contribute an extra \$1,000 in 2002. The \$1,000 increases in future years.</i></p>	<p>For most plans, no special contribution provisions exist for older employees. 457 and 403(b) plans have their own special catch-up provisions.</p>	<p>For those age 50 or older before the close of the calendar year, the maximum elective deferral is increased as follows. For 401(k), 403(b), government 457 and SARSEPs, by an additional \$1,000 in 2002, \$2,000 in 2003, \$3,000 in 2004, \$4,000 in 2005, and \$5,000 in 2006. For SIMPLE plans, by an additional \$500 in 2002, \$1,000 in 2003, \$1,500 in 2004, \$2,000 in 2005, and \$2,500 in 2006. The 2006 catch-ups subsequently will be adjusted for inflation.</p>	<p>Only plans that allow employees to make contributions may allow catch-ups. In order to permit these contributions, the plan must be amended to allow them. Although plans are not required to be so amended, many employers will want to do so. The catch-ups are exempt from most all limitations, including ADP/ ACP, §§ 415, 404, 457 and 402(g) testing. Detailed requirements are set forth in proposed Treasury Regulations.</p>
<p> <i>To administer catch-ups, plans must address numerous details.</i></p>			
<p> <i>Nongovernment tax-exempts may not allow the new catch-ups in their 457(b) plans</i></p>		<p>The prior 403(b) provision is eliminated in its entirety. The prior 457 specific catch-up remains intact, but modified: for the last 3 years preceding retirement, the contribution limit is twice the normally applicable limit (for example, the catch-up is \$22,000 (\$11,000 x 2) in 2002) and only this catch-up, not the new catch-up provision, is permitted for such three years for 457 plans.</p>	<p>Only 457 plans maintained by governments, not other tax-exempts, may allow these new catch-up provisions. Government 457(b) plans thus have two different, mutually exclusive catch-up provisions. Tax-exempts only may allow the 457 specific catch-up.</p>


<i>Provision and Key EGTRRA Change</i>	<i>Explanation and Prior Law</i>	<i>New Law</i>	<i>Comments</i>
<p>6. Per participant annual addition limit (415) for defined contribution plans</p> <p> <i>The per participant contribution limit is now the lesser of \$40,000 or 100% of compensation, plus catch-ups.</i></p>	<p>The sum of employer and employee contributions and forfeitures to individual participants is limited to the lesser of \$35,000 or 25% of compensation.</p>	<p>The \$35,000 limit increases to \$40,000 in year 2002. The limit will thereafter be adjusted for inflation in \$1,000 increments. The 25% of compensation limit increases to 100% of compensation. Effective for years beginning after Dec. 31, 2001.</p>	<p>The change from 25% to 100% of pay is a significant increase. Note the plan's overall contributions/deduction limit is 25% of pay (see B.1. below), thus limiting the increase for small employers. Catch-ups are not subject to the 415 limits.</p>
<p>7. Per participant defined benefit plan limits</p> <p> <i>The annual benefit payable from defined benefit plans increases dramatically, making these plans more attractive for high earners.</i></p>	<p>The law limits the annual lifetime annuity to the lesser of \$140,000 or 100% of the participant's high average pay. Benefits payable before Social Security Retirement Age are actuarially reduced.</p>	<p>\$140,000 limit increases to \$160,000 in year 2002 (as adjusted thereafter for inflation in \$5,000 increments). The actuarial reduction applies to benefits payable before age 62, instead of SSRA. Effective for limitation years ending after Dec. 31, 2001.</p>	<p>These and other changes allow for significantly greater benefits. High earners in their mid to late 40s should now consider defined benefit plans if large tax-deferred accumulations are desired. Add a 401(k) plan also, now that those are separately deductible (see B.2.).</p>

B. DEDUCTION IMPROVEMENTS



<p>1. Deduction limit for defined contribution plans and SEPs</p> <p> <i>The overall deductible contribution limit for profit sharing and 401(k) plans increases to 25% of aggregate pay, plus catch-ups, making profit sharing and pension plans more similar</i></p>	<p>The employer's deduction limit for SEPs, 401(k) and profit sharing plans was 15% of aggregate compensation of all participants. The limit for money purchase plans was the funding limit under Code § 412. To obtain the 415 limit for employees (see A.6.), many employers maintained both a pension and profit sharing plan.</p>	<p>The overall employer limit for both money purchase pension plans and profit sharing plans is 25% of aggregate participant compensation. Effective for years beginning after Dec. 31, 2001.</p>	<p>Many employers that had a money purchase pension plan, either alone or in combination with a profit sharing plan, will no longer need the money purchase plan (which required annual funding). Eliminating the pension plan involves several significant issues and must be carefully handled.</p>
<p>2. Elective deferrals subject to limits</p> <p> <i>Employee 401(k) contributions are deductible over and above the 25% of pay limit</i></p>	<p>Employee before-tax contributions to 401(k)s, SARSEPs, 403(b)s and SIMPLEs were treated as employer contributions subject to the 15% (or other) deduction limit. This sometimes limited the desired contribution amounts.</p>	<p>Employee contributions no longer are subject to the deduction limit (now 25%). Effective for years beginning after Dec. 31, 2001.</p>	<p>The amount of allowable contributions will increase. Employer's desired match and profit sharing contributions will not be affected by amount of employee contributions. 401(k) contributions, although not subject to any deduction limit, are still subject to the 402(g) limit and the 415 limit. (see A.2. and A.6. above)</p>

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<p>3. Change in definition of Compensation</p> <p> <i>The 25% of pay deduction limit is now based on gross compensation (inclusive of employee retirement and cafeteria plan deferrals)</i></p>	<p>Deductible employee contributions to §§ 401(k), 403(b), and 457(b) plans, and also to SIMPLE, 132(f) transportation and cafeteria plans, are excluded from the definition of compensation for purposes of calculating the employer contribution deduction limit (now 25%).</p>	<p>Such elective deferrals (including SARSEPs) are now included in the definition of compensation for purposes of calculating the deduction limit. Effective for years beginning after Dec. 31, 2001.</p>	<p>The deductible limitation in a defined contribution plan depends directly on compensation. Because the definition of compensation for deduction purposes now includes elective deferrals, the maximum deductible amounts will increase.</p>

C. VESTING

<p>1. Vesting of employer matching contributions</p> <p> <i>Matching contributions are now subject to a faster schedule</i></p>	<p>Currently, matching contributions may vest either under a five-year cliff or seven-year graded schedule for non-top-heavy plans</p>	<p>Matching contributions must vest either under a three-year cliff, or six-year graded, schedule. Generally effective for years beginning after Dec. 31, 2001.</p>	<p>The law applies the top-heavy schedule to matching contributions for most plans. Employers must decide whether the new schedule will apply just to new contributions, or also to existing accounts.</p>
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D. ROLLOVERS (PORTABILITY)

<p>1. Rollovers among various types of plans</p> <p> <i>Employees may move much more easily monies between different types of plans.</i></p> <p> <i>Employers are supposed to change operations on January 1, 2002</i></p>	<p>Rollovers to or from 457 plans to a non-457 plans not allowed. Rollovers from 403(b) plans only allowed to another 403(b) plan or IRA, not a qualified plan. Rollovers from qualified plan to 403(b) plan not allowed. Rollover from qualified to qualified plan allowed.</p>	<p>Rollovers to and from 403(b) plans to other plans or IRAs permitted. Rollovers to and from government 457 plans to other plans or IRAs permitted (although 10% additional tax on early distributions may now apply to such amounts rolled into 457 plans. 457 plans accepting rollovers must separately account for non-457 plan rollovers into such plans.) 20% mandatory withholding applies to distributions not rolled over. A new notice to employees describing the expanded rollover/withholding provision is required. Effective for distributions after Dec. 31, 2001.</p>	<p>Much of the confusion and antiquated barriers to rollovers among different types of plans is removed. However, § 457(b) plans maintained by nongovernment tax-exempts are left out of the enhanced portability picture.</p> <p>Plan operations must change effective January 1, 2002 to permit distributions <i>from plans</i> to comply with the expanded rollover options. Plans still are not required to accept any rollovers, including the new types, although most employers will choose to accept rollovers.</p>
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<p>2. Rollovers of IRAs into qualified plans</p> <p> <i>Rollovers between plans and IRAs are now generally allowed</i></p>	<p>IRA money generally could not be rolled into qualified plans. (An IRA with only qualified plan money, a “conduit IRA,” could be rolled from an IRA back to a plan).</p>	<p>IRAs may now be rolled over to a qualified plan, governmental 457(b) plan or 403(b) plan. Portability not extended to tax-exempt 457(b) plans. Effective for distributions after Dec. 31, 2001.</p>	<p>Although qualified plans are not required to accept IRA rollovers into it, many will. After-tax IRA money may not be rolled into plans. High earners in particular may benefit from rolling over their IRAs into plans. Tax exempt non-government 457(b) plans are again left out of the picture, and are not allowed to accept IRA rollovers.</p>
<p>3. Rollovers of after-tax contributions</p> <p> <i>After-tax monies may be rolled over</i></p>	<p>Rollovers of after-tax contributions are not permitted.</p>	<p>Rollovers of after-tax contributions from a qualified plan are permitted either to a defined contribution plan (if the plan agrees to separately account for the after-tax amounts) or to an IRA. Effective Dec. 31, 2001.</p>	<p>Employees might want to do this to shelter from tax the earnings on the after-tax monies. Employers might not want to hassle with after-tax accounting for these sums.</p>
<p>4. Spousal rollovers</p> <p> <i>Spouse beneficiaries may now roll over into plans, not just IRAs</i></p>	<p>If spouse received distribution after death of employee, rollovers permitted only to IRA, not to a plan.</p>	<p>Spouse rollovers to a qualified plan, 403(b) plan and government 457(b) plan also now permitted. Effective for distributions after Dec. 31, 2001.</p>	<p>Spouse beneficiaries now treated like spouse QDRO alternate payees. Nonspouse beneficiaries still may not rollover to either plan or IRA.</p>
<p>5. Rollover of hardship distributions</p> <p> <i>All kinds of hardships are ineligible for rollover</i></p>	<p>Hardship distributions of 401(k) contributions are ineligible for rollover. Other hardships were eligible for rollover or 20% mandatory withholding.</p>	<p>All hardship distributions, whether from 401(k) sources, profit sharing, or other sources, are ineligible for rollover to another plan. Effective for distributions after Dec. 31, 2001.</p>	<p>The new rule applies to qualified, 403(b) and government (not nongovernment) 457(b) plans. 10% voluntary withholding applies to these distributions.</p>
<p>6. Automatic rollovers of certain distributions</p> <p> <i>Unless participants elect otherwise, in several years plans will place small distributions into default IRAs the plan will select</i></p>	<p>In most instances plans may distribute vested benefits that do not exceed \$5,000 to the recipient, without the participant’s consent to the payout.</p>	<p>Generally for benefits that do not exceed \$5,000 but are over \$1,000, plans must select and roll the benefits over to an individual retirement account unless the distributee elects to receive the distribution directly or to roll it over to another account. This provision is not effective until the Department of Labor issues final regulations.</p>	<p>Fiduciary and practical issues arise with this new requirement. For example, the employer has fiduciary responsibility to select the default IRA investment, and also small IRA accounts may be eaten away by fees. Congress has given the Department of Labor until June 7, 2004 to address these concerns.</p>


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E. OTHER DISTRIBUTION ISSUES


<p>1. Disregarding rollovers for cash-out determination</p> <p> <i>Employers will not be penalized for accepting rollovers in small accounts</i></p>	<p>If a distributable event occurs, plans generally may provide that vested benefits of \$5,000 or less may be distributed (“cashed out”) without the participant’s consent. See D.6. above.</p>	<p>Rollover contributions may be disregarded when determining whether a vested benefit is \$5,000 or less. Effective for distributions after Dec. 31, 2001.</p>	<p>This provision is supposed to encourage plans to accept rollovers, by allowing them to ignore rollovers when applying the cash-out rules. Under JCWAA, this provision now also applies to pension and other plans subject to the annuity rules of Code § 417.</p>
<p>2. Anti-cutback rules</p> <p> <i>401(k) and profit sharing plans that are saddled (often mistakenly) with annuities may, and likely should, remove them. Merged plans also will become more efficient</i></p>	<p>A plan which eliminated a payment option with respect to previously accrued benefits was prohibited.</p>	<p>The anti-cutback rules, especially for merger situations, are relaxed. The IRS will issue appropriate regulations. Effective for years beginning after Dec. 31, 2001. Now, also, plans not subject to the joint and survivor rules may eliminate those features.</p>	<p>The relaxed rules will considerably ease plan administration, reduce legal fees and confusion. Allowing 401(k) and profit sharing plans to eliminate annuities is a great development.</p>
<p>3. Loans for self-employed</p> <p> <i>Partners, LLC members, S owners and sole proprietors may now borrow from plans</i></p>	<p>Owners of businesses who were self-employed were not allowed to borrow from plans.</p>	<p>Subchapter S shareholders, partners in partnerships, or LLCs, and sole proprietors may take plan loans. Effective after Dec. 31, 2001.</p>	<p>This change is welcome. It removes another distinction between Keogh plans and other plans.</p>

F. 401(k) SPECIFIC CHANGES

<p>1. Hardship distributions</p>	<p>To meet the safe harbor, regulations provide that participants must be prohibited from making § 401(k) contributions for 12 months after the hardship distribution.</p>	<p>IRS is directed to revise regulations to provide that safe harbor elective deferral prohibition period is reduced to six months. Effective for years after Dec. 31, 2001.</p>	<p>IRS guidance has been issued. It gives employers options to deal with this matter.</p>
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<p>2. Same desk rule</p> <p> <i>Finally!! Employers involved in restructuring, mergers and sales will now be able to more appropriately deal with their plans¹</i></p>	<p>401(k) plan distributions are permitted only under certain circumstances, one of which is “separation from service.” Under the IRS “same desk” rule, an employee performing the same job for a new employer in the same location (for example, when the employer is sold) generally did not have a “separation from service”, and therefore could not receive a distribution.</p>	<p>Severance from employment replaces “separation from service”, thus removing the considerable obstacle to paying benefits when businesses are sold or restructured. Effective Dec. 31, 2001, even for transactions occurring before then.</p>	<p>Very often, when a business changed hands, the seller could not pay 401(k) benefits to the employees, even though the employees were then working for a new, different employer. This frustrated and completely vexed the seller, buyer and employees, since often the seller had to keep those plan benefits of its former employees. The new rules will in many (but not all!) situations avoid this result, overturning the IRS’s longstanding and often criticized same desk rule policy.</p>
<p>3. Multiple use test for 401(k) and 401(m) testing repealed</p>	<p>The multiple use test prevents employers from using more than once the alternative limitation (two times or plus two) to pass the 401(k) Actual Deferral Percentage and 401(m) Actual Contribution Percentage tests.</p>	<p>The multiple use limit has been removed. Effective for years beginning after Dec. 31, 2001.</p>	<p>This change is welcome and may allow HCEs to contribute and receive greater contributions.</p>


G. NEW TAX INCENTIVES FOR RETIREMENT PLANS

<p>1. Tax Credit for Lower Income Savers</p> <p> <i>A new tax credit is intended to encourage lower paid employees to make § 401(k) contributions</i></p>	<p>New provision.</p>	<p>Certain individuals can receive a tax credit equal to a percentage of the individual’s contribution to an IRA, 401(k), 403(b), SIMPLE, SARSEP or government § 457(b) plan. Maximum credit is \$1,000, and phases out to \$0 if adjusted gross income is over \$50,000 for joint filers, \$37,500 for head of household, or \$25,000 for others. Effective for years beginning after Dec. 31, 2001 and ending in years beginning after Dec. 31, 2006.</p>	<p>In addition to the credit, the contributions are deductible (excludable from income). The IRS has issued two model notices; one in English (Announcement 2001-106) and another in Spanish (Announcement 2001-120). Employers are encouraged to use these notices.</p>
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¹ The author, Jeff Mandell, feels some personal satisfaction from this. He was one of the earliest vocal critics of the same desk rule, railing against its logic. See *The Distribution of § 401(k) Benefits in a Corporate Transaction: A Call for Reconciliation of the § 401(k) Regulations, the Same Desk Rule and GCM 39824* – Tax Management Compensation Planning Journal, BNA, 1995.


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2. Credit for plan start-up costs of small employers	New provision.	Smaller employers that first establish a retirement plan can receive a credit of up to \$500 per year for the first three years for plan costs. Employers eligible for the credit are those with 100 or fewer employees who received at least \$5,000 of compensation from the employer the preceding year. Effective for costs after Dec. 31, 2001 with respect to plans first effective after such date.	Unlike the credit in G. 1 above, this is an employer tax credit.
3. ESOP dividend reinvestment	C corporations may deduct ESOP dividends if paid in cash to participants or used to pay loan associated with the ESOP.	C corporations that reinvest the dividends in employer stock or give participants the option to reinvest the dividends in employer stock or to receive the dividends in cash may receive the deduction. Effective for years beginning after Dec. 31, 2001.	This change further enhances ESOPs.
4. Employer-provided retirement advice	No specific exclusion has existed for employer-provided retirement planning services to employees.	Qualified retirement planning services are now a fringe benefit an employer may provide tax-free to employees. Such services must be available in a non-discriminatory manner.	Congress wants to encourage plan sponsors to educate employees with respect to their plans and investments.

H. TOP-HEAVY IMPROVEMENTS

<p>1. Top-heavy rules</p> <p> <i>The top-heavy rules and the new changes are important which small employers in particular must consider</i></p>	<p>A top-heavy plan is one in which the employer's owners and officers have 60% or more of the plan's benefits. A top-heavy plan must provide minimum employer funded contributions and faster vesting.</p>	<p>The top-heavy requirements are complex which the new law has simplified. Matching contributions may now help satisfy the employer contribution requirements. Certain 401(k) plans with employer contributions are now exempt from the top-heavy rules. Effective for years beginning after Dec. 31, 2001.</p>	<p>Employers and their advisors must consider the changes. Small employers might want to redesign their 401(k) plans.</p>
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I. INDIVIDUAL RETIREMENT ACCOUNTS

<p>1. IRS contribution limit</p> <p> <i>The IRA limits have increased and age 50 catch-ups are allowed</i></p>	<p>The pre-tax IRA contribution maximum limit is \$2,000 per year.</p>	<p>The limit increases as follows:</p> <p>2002 through 2004 \$3,000</p> <p>2005 through 2007 \$4,000</p> <p>2008 and thereafter \$5,000, as adjusted for inflation.</p> <p>For individuals age 50 or older, the maximum is increased to by an additional amount, as follows:</p> <p>2002 through 2005 \$500</p> <p>2006 and thereafter \$1,000</p>	<p>The IRS and pension increases reflect Congress' desire to increase America's retirement savings.</p>
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The information in this chart does not cover all of the EGTRRA employee benefit and IRA provisions. The EGTRRA provisions expire after year 2010; however, the government and practitioners believe such sunset will be lifted and the provisions will not be rolled back.