

# **Economic Growth and Tax Relief Reconciliation Act of 2001**

## **Introduction to EGTRRA**

The Economic Growth and Tax Relief Reconciliation Act of 2001, EGTRRA, is one of the **most significant pension legislative acts ever** – ranking with ERISA 1974 and the Tax Reform Act of 1986. Contrary to almost all legislation since ERISA, it was **designed to spend taxes, not raise them**. This makes it enjoyable, but because of the sheer magnitude of the changes, we have provided the following index-links to help you locate information on specific changes.

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## **DEFINED CONTRIBUTION PLANS**

### **Defined Contribution Plan Limits Increased**

#### **Annual Addition Limit**

Both the dollar and percentage limits on annual additions (i.e. contributions and forfeitures) have been increased. The maximum dollar limit was increased from \$35,000 for 2001 to \$40,000 for 2002 and will continue to increase in \$1,000 increments. The percentage-of-salary limit was increased from 25% to 100% allowing low to mid-wage earners to contribute substantially more. To give "equitable treatment" to all types of qualified plans, the new 100% of compensation limit also applies to 403(b) annuities and 457 plans.

#### **Elective Deferral Limit**

The elective deferral limit for 401(k), 403(b), and 457 plans will increase from \$10,500 in 2001 to \$11,000 in 2002 with additional \$1,000 annual increments until the limit reaches \$15,000 in 2006. The \$15,000 is indexed for inflation in \$500 increments after 2006.

<b><u>Calendar Year</u></b>	<b>401(k), 403(b) &amp; 457 Elective Deferral Limit</b>	<b>Simple – IRA Simple – 401(k)</b>
2002	\$11,000	\$7,000
2003	\$12,000	\$8,000
2004	\$13,000	\$9,000
2005	\$14,000	\$10,000
2006	\$15,000	\$500 COLA
Thereafter	\$500 COLA	\$500 COLA

As shown above, the elective deferral limits under SIMPLE Plans will also increase except the scheduled increases stop a year earlier but the COLA is a year earlier, as well.

Modifying a 457 special catch-up rule for the three years prior to retirement, the dollar limits described above will be doubled for 457 plans.

**Compensation Limit**

The compensation limit has been increased from \$170,000 for 2001 to \$200,000 in 2002. The \$200,000 limit will be indexed by rounding to the nearest increment of \$5,000 for years after 2002.

**Catch-up 401(k) Contributions**

EGTRRA establishes a new concept of extra *catch-up contributions* for older participants (i.e. those who are at least age 50 at the close of the plan year). Catch-up contributions are additional elective contributions for participants **age 50 and older** who have already made the maximum legal or plan deferral.

The maximum catch-up contributions are:

<b>401(k), 403(b) &amp; 457</b>		
<b><u>Calendar Year</u></b>	<b><u>Catch-up Contributions</u></b>	<b><u>Simple – 401(k)</u></b>
2002	\$1,000	\$500
2003	\$2,000	\$1,000
2004	\$3,000	\$1,500
2005	\$4,000	\$2,000
2006	\$5,000	\$2,500
Thereafter	\$500 COLA	\$500 COLA

A very important aspect of catch-up contributions is that they do not count against elective deferral limits, 415 annual addition limits, or 404 deduction limits. This means that a participant age 50 or older could potentially contribute \$12,000 and have a total of \$41,000 added to his account in 2002 - the \$11,000 maximum elective deferral plus \$1,000 in catch-up contributions and a total of the \$40,000 415 annual addition limit plus \$1,000 in catch-up contributions.

Also, if age 50 or older, a highly compensated employee is prohibited from contributing due to the special 401(k) non-discrimination test, he can still make the additional catch-up contributions.

The right to make catch-up contributions must be offered to all eligible employees on a non-discriminatory basis.

### Repeal of the Multiple Use Test

The **Multiple Use Test** requires that after testing elective deferrals under the Average Deferral Percentage Test (ADP), and after testing matching contributions under the Average Contribution Percentage Test (ACP), a combined test of the ADP and ACP would have to be run, which could result in additional refunds to the highly compensated employees. This was called the **Multiple Use Test** and is eliminated by EGTRRA for plan years beginning on or after 1/1/2002.

### More Rapid Vesting of Matching Contributions

Beginning 1/1/2002 more rapid minimum vesting is required for employer matching contributions. These new matching contribution schedules are shown next to the minimum schedules for other employer contributions (e.g. profit sharing). Plans may choose between the Graded or Cliff Vesting schedules:

#### **Minimum Vesting Schedules**

<u>Years of Service</u>	<u>Graded Vesting Schedule Alternative</u>	
	<u>Matching %</u>	<u>Profit Sharing %</u>
less than 2	0%	0%
2	20%	0%
3	40%	20%
4	60%	40%
5	80%	60%
6	100%	80%
7 or more	100%	100%

  

	<u>Cliff Vesting Schedule Alternative</u>	
less than 3	0%	0%
3	100%	0%
4	100%	0%
5 or more	100%	100%

If you have matching contributions and your regular vesting schedule does not meet one of these new minimum schedules, you must change beginning 1/1/2002.

### Top Heavy Rules Modified

EGTRRA extends the provision that a safe-harbor 401(k) plan is not top-heavy to the matching contribution design-based safe-harbor. Therefore, now whether or not you use (a) the 3% non-elective or (b) the dollar-for-

dollar match up to 3% and 50¢/dollar for the next 2% you are deemed to not be a top-heavy plan.

Furthermore, in non-safe-harbor 401(k) plans, all matching contributions are now taken into account to determine whether or not the top-heavy minimum contribution requirements are met.

Finally, applicable to all plans, the 5-year distribution add back rule has been modified so that distributions only during the one-year period prior to the determination date are taken into account, except that the current 5-year rule is retained for in-service distributions. Also, the balances of terminated employees are not considered after one-year (rather than the current 5-year period). All of these provisions are effective for Plan Years beginning on or after 1/1/2002.

### **Employer Deductions Increased**

Effective for employer tax years beginning on or after 1/1/2002, the deduction limit for profit sharing and stock bonus plans has been increased from 15% to **25% of compensation**. Also, compensation now includes 401(k) elective deferrals and Section 125 cafeteria plan contributions.

Besides being included in the definition of compensation, 401(k) contributions are deductible, separately, in addition to the 25% of compensation limit. Therefore, the employer may deduct employer contributions up to 25% of compensation and the 401(k) elective deferrals, separately.

Planning Tip: If you have maintained both a profit sharing plan and a money purchase plan to ensure deductibility of your contributions, you can now provide for the same level of contributions under a profit sharing plan alone. Therefore, there is no need for the money purchase plan. You may want to merge it with your profit sharing plan. If you do merge a money purchase plan, you may need to apply the Joint & Survivor rules to the entire balance in the merged plans.

### **After-Tax Roth Contributions to 401(k) and 403(b) Plans**

Beginning for tax years after 2005, 401(k) and 403(b) plans can provide for a "qualified Roth contribution program" under which an employee may elect to designate any portion of his elective deferral as an after-tax Roth contribution. Under a "qualified Roth contribution program" contributions are after-tax as they are deposited, but "qualified distributions" are not includable in income. Therefore, any investment gain is tax-free. A "qualified distribution" is one made after 59½, on death, or due to disability.

If I wasn't so excited about this provision, I'd worry about the recordkeeping complexities. With this personal observation aside, let's all not get too excited until we're closer to the delayed effective date.

### **Hardship Distributions**

For hardship distributions after 12/31/2001:

- (a) the "safe harbor" 12 month suspension of 401(k) contributions is decreased to a six month suspension, and
- (b) the entire hardship distribution (including employer monies) is not eligible for rollover. Therefore, it will be subject to the 10% voluntary withholding rules.

### **DEFINED BENEFIT PLAN**

#### **Defined Benefit Plan Limits Increased**

The maximum annual dollar limitation is increased from \$140,000 for 2001 to \$160,000 for 2002. The \$160,000 limit is then indexed beginning in 2003 for inflation to the next lower \$5,000 multiple.

Although this is a significant increase, even more dramatic for early retirees is that the \$160,000 limit can be paid in full at age 62 rather than, as under old law, reduced from the social security retirement age back to age 62. Furthermore, the dollar limit is increased if benefits are paid after age 65 (also, rather than the social security retirement age).

#### **Compensation Limit**

The compensation limit has been increased from the \$170,000 for 2001 to \$200,000 in 2002. The \$200,000 limit will be indexed by rounding to the nearest increment of \$5,000 for years after 2002.

#### **Repeal of Current Liability Full Funding Limit**

The current liability full funding limit is increased to 165% in 2002, 170% in 2003, and then repealed in 2004. Therefore, after 2003, the only full funding limit will be the mathematically correct old accrued liability full funding limit. Until then, we still have to put up with the revenue generating current liability full funding, albeit at higher percentage adjustments.

## **Higher Deductions for Under-Funded Plans and When Plan Terminates**

The rule which allows deduction for contributions up to 100% of unfunded current liability has been extended to all defined benefit plans. Therefore, beginning in 2002, EGTRRA now extends this rule to plans of less than 100 participants and multiemployer plans.

There is a limitation on this extension for plans with less than 100 participants, the current liability does not include benefit increases for highly compensated employees, which result from an amendment made or effective within the last two plan years.

In the year of termination, there is a special limit that allows deduction of the amount required to make the plan sufficient. Also, the 10% excise tax on non-deductible contributions is eliminated for amounts up to the accrued liability full funding limit.

## **Multiemployer Plans**

First, the law repeals the 100%-of-compensation rule for multiemployer plans. Therefore, multiemployer plan benefits are only capped by the dollar limitations under §415. As noted earlier, the annual dollar limit was increased to \$160,000 payable at age 62.

Second, multiemployer plans are not aggregated with non-multiemployer plans for the single employer plan 100%-of-compensation test. Also, remember a multiemployer plan has never been aggregated with any other multiemployer plan for either the 100%-of-compensation limit (which has now been eliminated) or for the dollar limit under Code §415.

## **EMPLOYEE STOCK OWNERSHIP PLANS**

### **Deduction of Dividends**

A C-Corporation can deduct dividends that are:

- (a) paid to the participant in cash, or
- (b) used to make payments on an ESOP loan

The new law further allows the deduction of dividends where the participant voluntarily chooses either to receive the dividends in cash or reinvest the dividends in employer securities within the plan.

### **Prohibited Allocation of Stock for S-Corps**

Generally under prior law, a 50% excise tax was imposed on *prohibited allocations* of employer securities that had been sold to an ESOP in a non-recognition-of-gain transaction. Also the individual receiving prohibited allocations is currently taxed on these amounts. A prohibited allocation is one made to a disqualified person within the later of 10 years or the date the final loan payment is made. A disqualified person is one who is related to the taxpayer seeking non-recognition-of-gain, or one who owns (under Section 318(a) attribution) more than 25% of the outstanding stock.

The new law keeps the 50% excise tax on the prohibited allocation to the disqualified person. However, EGTRRA expands the prohibited allocation definition for S-Corps to include any accrual of any portion of the assets of an ESOP that are attributable to the employer's S-Corporation stock for the benefit of a disqualified person during a non-allocation year. A disqualified person means a deemed **10-percent shareholder** or a member of a family which is a deemed 20-percent family shareholder. Deemed-owned shares include (a) S-Corporation stock allocation under the plan and (b) the share of S-Corporation stock, which the plan holds but has not yet allocated. The share of unallocated stock is determined by assuming all of the unallocated stock was distributed in the same proportions as the most recent allocation. Non-allocation year is any plan year of an S-Corporation ESOP if at any time disqualified persons own at least 50% of the total outstanding shares. This would include deemed-ownership.

## **DISTRIBUTION / LOANS**

### **Minimum Distribution Requirements**

On January 17, 2001 the IRS issued new proposed rules on minimum distributions, which greatly simplified the calculation of the minimum distribution amount payable beginning in the calendar year in which a participant attains age 70\_. These rules also make the designation of a beneficiary less restrictive. EGTRRA directs the IRS to issue a new mortality table in order to reflect current life expectancy due to recent increases in longevity.

## **Early Distribution Allowed Under 457 Plans for QDROs**

457 Plans can only make distributions on account of:

- attainment of age 70½
- separation from service, or
- an unforeseen emergency

Effective 1/1/2002, EGTRRA now permits early distributions under **Qualified Domestic Relations Order** (QDROs). A QDRO is an order that redirects a portion of the participant's benefit to an alternate payee. An alternate payee can be a spouse, former spouse, child or other dependant. A distribution under a QDRO is taxable to the participant unless the alternate payee is the spouse or former spouse.

## **Elimination of Same Desk Rule**

The "same desk" rule is the name given to the IRS's long-standing position that if, on the sale of a company, an employee continued to perform the same duties for the successor employer, the employee had not "separated from service" but had had a "severance from employment". This position created difficulties because you could not distribute from a plan until a "separation from service".

EGTRRA modifies the 401(k) allowable distribution events to include a "severance from employment". Therefore, a plan can, but is not required to, make distribution on the sale of a company or subsidiary where an employee continues in the same position for the successor employer.

## **Plan Loans Allowed to Self-Employed and Owner Employees**

Effective 1/1/2002, qualified plan loans to sole proprietors, partners and Sub-chapter S owner employees are no longer prohibited transactions. This *levels the playing field* for all participants in qualified plans. Loans from IRAs are still considered prohibited transactions.

## **Rollovers – Qualified Plans, 457 Plans, 403(b) Annuities, and IRAs**

*Eligible Rollover Distributions* can be rolled over or directly transferred to an eligible individual account plan. An *Eligible Rollover Distribution* is the taxable portion of a distribution, which is paid over less than 10 years, and is not a hardship withdrawal, death benefit to a non-spouse beneficiary, or a

70\_ minimum distribution. An eligible individual account plan was defined only to include qualified plans and Individual Retirement Accounts (IRAs).

Effective 1/1/2002, the definition of eligible individual account plans has been expanded to include 457 plans and 403(b) annuities. Therefore, there is now portability between all types of plans: qualified plans, 457 plans, 403(b) annuities and IRAs. If not a direct trustee-to-trustee transfer, a rollover must be made within 60 days.

After-tax contributions from a qualified plan are now allowed to be rolled over into another qualified plan or IRA (these include 457 & 403(b)). These after-tax rollovers are only allowed through direct trustee-to-trustee transfers. Also, after-tax distributions from an IRA are only allowed to be transferred to another IRA.

Now expanded written explanations for eligible rollover distributions and tax consequences are required. The IRS will issue a revised model notice.

Finally, if an involuntary distribution exceeds \$1,000 and the vested accrued benefit is not more than \$5,000, the default option is a rollover to an IRA. This will be effective after the Department of Labor (DOL) issues final regulations. Don't hold your breath!

## **CREDITS / USER FEES**

### **Credit for Elective Deferrals and IRA Contributions**

To encourage low-end, middle-income taxpayers to save for their retirement, a *temporary* tax credit for elective deferrals or IRA contributions has been established. The tax credit is equal to the "applicable percentage" times the amount contributed up to \$2,000. The "applicable percentage" is:

<b><u>Single</u></b>	<b><u>Joint</u></b>	<b><u>Applicable Percentage</u></b>
\$0 - \$15,000	\$0 - \$30,000	50%
\$15,001 - \$16,250	\$30,001 - \$32,500	20%
\$16,251 - \$25,000	\$32,501 - \$50,000	10%
Over \$25,000	Over \$50,000	0%

The tax credit equal to the "applicable percentage" times the amount of contributions is effective for calendar years 2002 through 2006.

### **Credit for Plan Start-Up Costs for Small Employers**

To encourage small employers (no more than 100 employees) to establish plans, EGTRRA establishes a 50% tax credit for start-up costs to create or maintain a new retirement plan. The credit is limited to \$500 per year for each of the first three years of a plan.

### **IRS User Fees Eliminated for Eligible Small Employers**

EGTRRA eliminates the IRS user fees for a determination letter request for an eligible small employer (no more than 100 employees with at least one non-highly compensated employee). This rule applies to a determination letter request that is made before (a) the last day of the fifth plan year or (b) the end of the applicable remedial amendment period.

This means that a small employer who established a plan in 1993 or later may qualify for waiver of the GUST user fee.