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Special Benefits Edition of e-News: From the Labor, Employment and Benefits Group of Robinson & Cole

This special edition of e-News is devoted to the Economic Growth and Tax Relief Reconciliation Act of 2001, signed into law yesterday by President Bush.

We hope you enjoy this special edition of e-News. If you know of others who would enjoy receiving this online newsletter (or if you would like to discontinue receiving e-News), pleaseclick here and send us an e-mail message. If you would like certain information covered in future issues, please let us know. We welcome your feedback.

New Tax Bill Makes Major Changes to Employee Benefits

On June 7, 2001, the President signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001. Although the Act is perhaps best known for its tax cut provisions, the Act makes more substantive changes to employee benefit programs than any law since 1986.

It is important to note that the Act contains an unusual sunset clause stating that none of the Act's provisions apply to taxable years or plan years beginning after December 31, 2010. Accordingly, unless Congress renews the Act prior to that date, all of the changes discussed below will expire and the law will revert to its state prior to enactment.

Qualified Plan Compensation Limit

The Act raises the amount of compensation that can be used: for non-discrimination testing and for calculating the amount of benefits permitted under defined benefit plans and contributions under defined contribution plans from $170,000 to $200,000, effective in 2002. This amount will be adjusted for cost-of-living increases thereafter in $5,000 increments (current law allows for changes in $10,000 increments).

Defined Contribution Plans

Previously, total annual additions to a defined contribution plan were limited to the lesser of $35,000 or 25% of compensation. The Act raises the $35,000 limit to $40,000, adjusted for cost-of-living increases in $1,000 increments (current law allows for changes in $5,000 increments). The Act also changes the percentage limit from 25% of compensation to 100% of compensation. The 100% limit now applies to 457 plans, increasing the current 33 1/3% limit, and to 403(b) arrangements, as the Act repeals the exclusion allowance rules previously applicable to such arrangements. Effectively, the increase to 100% of compensation will allow for larger contributions for lower-paid employees than are currently permitted under the 25% of compensation limit.

The Act provides that elective deferrals made by employees will no longer be counted as employer contributions for the purpose of calculating the employer's limit on deductible contributions to a qualified plan.

The Act also changes the limit on deductible employer contributions to profit sharing plans and stock bonus plans from 15% to 25% of compensation of employees covered by the plan. The Act revises the definition of compensation to include elective deferrals and any amount contributed by the employer at the election of the employee, such as 125 or 457 deferrals. Pursuant to the Act, money purchase plans are to be treated as a profit sharing or stock bonus plans for the purpose of the deduction rules. Effectively, this means that there are few reasons to maintain money purchase plans beginning in 2002.

The Act revises the current law regarding plan loans to permit more than 5% shareholders in S corporations and more than 10% owners of unincorporated trades or businesses to take participant loans from qualified plans (subject to the same rules as other participants).

All of these changes apply to plan years beginning on or after January 1, 2002.

401(k), 403(b) and 457 Deferrals

New contribution limits for elective deferrals to 401(k) plans, 403(b) arrangements and 457 plans are also included in the Act. In 2002, the elective deferral limit will be $11,000. The limit is scheduled to increase to $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006. After 2006, the contribution limit will be adjusted for cost-of-living increases in $500 increments. For 457 plans, in the participant's last three years of participation before retirement, the participant may contribute twice the contribution limit applicable for each of those years. Unlike the current law, the Act provides that deferrals to 401(k) plans or 403(b) arrangements by a participant in a 457 plan do not reduce the amount of elective deferrals the participant may make to the 457 plan.

The Act also provides for catch-up contributions by those who reach the age of 50 within a

plan year. The provision allows the deferral of an additional $1,000 in 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005, and $5,000 in 2006. Beginning in 2007, the amount of the catch-up contribution will be adjusted for cost-of-living increases in $500 increments. Participants in 457 plans will not be permitted to make catch-up contributions in their last three years of participation before retirement. Employers may elect to match catch-up contributions. Catch-up contributions are not subject to non-discrimination rules, except that all eligible participants must be allowed to participate in the same manner.

The Act also mandates an accelerated vesting schedule for employer matching contributions equivalent to that required for top heavy plans. Employer matches must either vest completely after three years of service, or vest in increments of 20% beginning after two years of service with full vesting occurring after six years of service. The use of a more rapid vesting schedule is also permitted. This vesting requirement is effective for plan years beginning in 2002, but also applies to matching contributions made prior to 2002. The new vesting schedule applies only to employees who have at least one hour of service in a plan year beginning in 2002 or later.

The Act repeals the multiple use non-discrimination test for 401(k) plans beginning in 2002.

Under the Act, participants who have received hardship withdrawals may resume making elective deferrals six months after a hardship withdrawal rather than after twelve months as currently required. This provision applies to distributions made in 2002 or later.

The Act creates a tax credit for low to moderate-income taxpayers for elective deferrals to a 401(k) plan, 403(b) arrangement, 457 plan or IRA. The credit applies to the first $2,000 of an individual's elective deferrals. The amount of the credit is calculated based upon the adjusted gross income of the individual claiming the credit, and is reduced by any taxable distributions from a qualified plan to the participant during the taxable year. The credit is in addition to the tax exclusion currently provided for elective deferrals. The credit will only be available for tax years 2002 through 2006.

Under the Act, 457 plan assets can be transferred to a spouse under a qualified domestic relations order (QDRO). This provision is effective for transfers, distributions and payments made in 2002 or later.

Defined Benefit Plans

The Act changes the total annual benefit limit for defined benefit plans from $140,000 to $160,000. This provision applies to plan years ending on or after January 1, 2002. The limit will continue to be adjusted for cost-of-living increases in $5,000 increments. Currently, the total annual benefit limit must be adjusted for employees who begin receiving benefits before or after the Social Security retirement age. Changes made in the Act provide that the benefit limit is not reduced where the employee commences receiving a benefit before age 62. The Act also provides that the limit may be increased for an employee whose benefit

commences after age 65. A plan may opt to increase benefits for eligible participants whose benefits commenced prior to the date of the Act to account for this change.

The Act phases out the current liability full funding limit for defined benefit plans by increasing the limit to 165% in 2002, and to 170% in 2003. In 2004, the current liability funding limit is repealed. After the repeal of the limit, the maximum amount deductible by the employer is the excess of the plan's accrued liability over the value of the plan's assets. The employer may elect not to subject most non-deductible contributions to the excise tax for excess contributions beginning in 2002.

The Act also permits many defined benefit plans to perform valuations of the plan based on the past year's data beginning in 2002. The current rule requires valuations based on the current year's data only.

SIMPLE Plans

The Act raises the limit on contributions to SIMPLE plans to $7,000 in 2002, $8,000 in 2003, $9,000 in 2004, and $10,000 in 2005. After 2005, the limit will be adjusted for cost-of-living increases in $500 increments.

SIMPLE plan participants who reach the age of 50 in a plan year are also eligible to make catch-up contributions. An eligible participant may make a catch-up contribution of $500 in 2002, $1,000 in 2003, $1,500 in 2004, $2,000 in 2005 and $2500 in 2006. After 2006, the catch-up contribution will be adjusted for cost-of-living increases in $500 increments.

Individual Retirement Accounts

The Act increases the annual contribution limit for traditional and Roth IRAs for the first time in 20 years. The limit will increase from $2,000 to $3,000 in 2002, to $4,000 in 2005, and to $5,000 in 2008. After 2008, the contribution limit will be adjusted for cost-of-living increases in $500 increments.

The Act also provides an opportunity for holders of both types of IRAs to make catch-up contributions beginning in the taxable year in which the holder reaches the age of 50. A $500 catch-up contribution may be made beginning in 2002. In 2006, the amount of the contribution increases to $1,000. After 2006, catch-up contributions will be adjusted for cost-of-living increases.

For plan years beginning after December 31, 2002, qualified plans may elect to allow participants to make IRA contributions to separate accounts established by the plan. These changes are similar to the VDEC rules of the mid-1980s. These accounts will be deemed IRAs, and will not be subject to Code rules regarding eligible retirement plans or ERISA rules regarding funding, vesting, reporting or distribution. ERISA fiduciary rules will apply.

Top Heavy Rules

The Act revises the top heavy definition of key employee to apply to a smaller range of employees. The Act also permits employer matching contributions to be considered in determining if the plan has provided the required minimum top heavy contribution for non-key employees. Both of these provisions are effective for plan years beginning in 2002.

Top heavy plans using cash or deferred arrangements may avoid being deemed top heavy if the plan utilizes the testing safe harbor provisions.

Distributions

The Act provides that when the assets of a plan are transferred, the new plan need not offer all of the forms of distribution offered under the prior plan as long as (1) the transfer was a permissible, direct transfer between two plans, (2) the transfer was made pursuant to a voluntary election by the participant made after the participant received notice of the consequences of the election, and (3) a lump sum form of distribution is available under the new plan. This provision does not apply to mergers or involuntary transfers that are direct transfers. The Act makes it clear that the elimination by a plan amendment of a form of distribution previously available under the plan is permissible as long as a lump sum payment is available, and the payment is based on the same or greater portion of the participant's account as the eliminated benefit. Both provisions are effective for plan years beginning in 2002 or later. Neither provision alters the rules regarding joint and survivor annuities for pension plans.

The Act directs Treasury to issue regulations allowing for the reduction or elimination of early retirement benefits, retirement-type subsidies or optional forms of benefit as long as the elimination of the benefit does not adversely affect the rights of participants in more than a de minimis way. This provision takes effect in 2004 unless an earlier date is specified by Treasury.

The Act also provides that rollover amounts do not need to be considered in calculating the value of an accrued benefit in determining whether an involuntary distribution ($5,000 cashout) may be made. This applies to distributions made in 2002 or later.

If an involuntary distribution of more than $1,000 is made, unless the distributee affirmatively elects otherwise, the Act requires that the distribution must be rolled into an IRA or other qualified investment vehicle. The Act instructs the Department of Labor to issue regulations setting forth safe harbors for the selection of investment vehicles for involuntarily distributed funds within three years of the enactment of this provision. This provision is not effective until the regulations are issued.

The "same desk rule" is repealed by the Act. The Act permits distributions upon severance

from employment rather than separation of service. The plan may provide what events constitute severance of employment. This change applies to distributions made in 2002 or later, regardless of when severance of employment occurred.

Rollovers

The Act contains several provisions increasing the flexibility of rollovers. Beginning in 2002, distributions from 401(a) plans, 403(b) arrangements or 457 plans may be rolled over into another 401(a) plan, 403(b) arrangement or 457 plan. Also beginning in 2002, distributions from contributory IRAs may be rolled over into 401(a) plans, 403(b) annuities, 457 plans or other IRAs. After-tax employee contributions may be rolled into other qualified retirement plans or IRAs. Qualified plans receiving such distributions must utilize separate accounts for after-tax contributions. After-tax contributions from an IRA may not be rolled over to a 401(a) plan, 403(b) arrangement or 457 plan. The current law, that 401(a) plans, 403(b) plans and 457 plans are not required to accept rollovers, remains unchanged.

The Act authorizes Treasury to waive the 60-day rollover requirement in instances where applying the requirement would be against equity or good conscience, such as in situations involving disaster, casualty, or events beyond the control of the distributee. Current law requires rollovers be made within 60 days after distribution with no exceptions. This provision applies to distributions made in 2002 or later.

The Act also has increased the notice requirements for rollovers. Plan administrators of a plan making a distribution are required by the Act to provide a written explanation of the circumstances under which distributions from the plan receiving the distribution may be subject to restrictions and taxes that differ from those that apply to the plan making the distribution. The Act requires that a safe harbor rollover notice be created to meet the requirements of this provision, and states that no plan will be held liable for violating this provision until 90 days after the safe harbor notice is issued.

Beginning in 2002, if allowed by the receiving plan, surviving spouses may roll over distributions from a deceased spouse's plan to a qualified plan, 403(b) annuity, or 457 plan in which the surviving spouse participates.

Tax Credit and Waiver of User Fees for New Plans

The Act creates a tax credit for employers of up to $500 for administrative and retirement-education expenses involved in establishing a new plan. To be eligible for the credit, in the preceding year the employer must have employed less than 100 employees, employed at least one non-highly compensated employee, and must not have had a plan within the past three years benefiting substantially the same employees participating in the new qualified plan. The credit applies to costs incurred or paid in taxable years after December 31, 2001. The credit may be claimed in each of the plan's first three years. Expenses offset by the credit are not deductible.

Beginning in 2002, employers with fewer than 100 employees and at least one non-highly compensated employee will be eligible for a waiver of the applicable User Fee for determination letters requested during the first five years of the plan. This provision does not apply to requests regarding prototype plans by individuals intending to market the plan, but does apply to users of prototype plans requesting determination letters. This provision applies only to requests made in 2002 or later.

Reductions in Future Accrued Benefits

The Act revises the notice requirement for plan amendments significantly reducing the rate of future benefit accruals to include instances in which early retirement benefits are being eliminated or significantly reduced. The Act also creates an excise tax of $100 per day per individual not receiving notice, capped at $500,000 a year, for failure to give notice of a significant reduction of any type of future accrued benefit. The tax does not apply if the failure was unknown and occurred despite reasonable diligence by the plan, or if the failure is corrected within 30 days. The Act reserves the previous penalty for failure to give notice, treating the plan as if the amendment was never made, for situations in which the failure to give notice is egregious. Although this provision is effective on the date of enactment, until regulations are issued regarding this section, a plan will be treated as meeting the requirements of this section if it makes a good faith effort to comply with the notice requirement.

Retirement Advice

The Act makes it clear that employer-provided retirement advice is a fringe benefit not includable in gross income. To be non-discriminatory, a plan must offer advice on "substantially the same terms" to employees who are normally provided retirement planning services. This provision is effective in 2002.

ESOPs

The Act provides that employers are permitted to deduct dividends paid to an S corporation ESOP if employees are permitted to take the dividend in cash or to reinvest it beginning in 2002. The Act also provides that, beginning in 2005, if the ESOP is not the majority shareholder in the S corporation, restrictions apply to shareholder employees relative to the allocation of stock.

Qualified Plan Amendments

Many of the foregoing provisions will require amendments to qualified plans. The IRS has indicated that within the next month it will probably issue model amendments that can be

adopted by qualified plans to comply with the new laws. However, the IRS also has indicated that it will not extend the deadline (generally December 31, 2001) for qualified plans to be amended to comply with current laws and regulations.

Educational Assistance Plans

The Act provides that both undergraduate and graduate level courses qualify for educational assistance plans, effective for courses beginning after December 31, 2001. The Act removes the December 31, 2001 sunset clause for such plans so that employers can continue to maintain educational assistance plans after this year.

Dependent Care

Although the Act does not change any provision regarding dependent care flexible spending accounts, the Act does increase the amount of the existing dependent care credit. The Act allows $3,000 in expenses to be taken into account if one qualifying individual is claimed, and $6,000 if two such qualifying individuals are claimed. Individuals who participate in a flexible spending account and are able claim two or more qualifying individuals may still be eligible for a portion of this credit, despite the use of a flexible spending account, as a result of the Act's increase of expenses taken into account in determining the amount of the credit. This provision is effective for taxable year 2003.

Please Feel Free to Contact Us for More Information

If you have any questions about these changes, please contact Bruce Barth, John Tannenbaum or Dawn Zammitti in our Hartford office.

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