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Introduction – Changes to Employer Plans Under 2001 Tax Relief Act

This newsletter is almost solely devoted to summarizing the changes to employer-sponsored retirement plans as created by the enactment of the "Economic Growth and Relief Reconciliation Act of 2001 (EGTRRA)." These changes are quite numerous, and, in terms of substance, are very far reaching. These changes will certainly induce more employers to establish qualified plans and other retirement plans, and will lead to larger contributions. These changes also allow increased competition within the retirement industry, as explained in the first summary.

IRAs Within Certain Employer Plans

Obviously this change impacts both qualified plans and IRAs. In a way, this law change is a return to the past, although many may not remember it. From 1984 - 1986, it was permissible for a qualified plan to be written to accept IRA contributions. For whatever reason, at that time, the vast majority of qualified plans and third-party administrators of qualified plans did NOT really want the additional work associated with servicing such contributions. The law was quickly changed to repeal the right to make IRA contributions to a qualified plan. This right ended as of 12/31/86.

It now appears that the qualified plan industry wants this additional right. This is the "Super Store" approach, as employees will be able to have all of their retirement dollars (qualified plan and IRA) with the same service provider. There may well be reasons for IRA custodians to be concerned about the possible loss of IRA business to the large service providers.

Both traditional IRA and Roth IRA contributions will be able to be made to a qualified employer plan, which is defined to be a 401(a) plan, a 403(a) annuity plan, or a 403(b) annuity plan.

In order for the contribution to be treated as a traditional IRA or Roth IRA contribution, it would have to be designated as such. These contributions will receive special treatment under a qualified plan. In general, these contributions will not be treated as part of the qualified plan for all of the "qualified plan" rules (e.g. the $5,000 cash-out rule or the survivor benefit rules, etc). The concept is that they will be treated as an IRA plan within the qualified plan. However, the ERISA rules governing exclusive benefit, fiduciary, and co-fiduciary rules will apply.

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CORRECTION: The following are corrections to CWF's May 2001 "corrected" Pension Digest. Paragraph 2 on page 2 should be corrected to read: "The new deadline for the withdrawal of an excess contribution will be the day prior to June 1 (i.e. May 31) rather than 4/15 plus extensions. Paragraph 4 on page 2 should read "Entities other than individuals can make contributions to Education IRAs. However, total contributions to any Education IRA for a given year (beginning with 2002) may not exceed $2,000. The income limits which dictate whether or not an individual is allowed to contribute to an Education IRA do not apply to these "other" entities.

Increase in Deduction Limit for Profit Sharing Plans

The sponsoring employer is entitled to take a deduction for the amount it contributes to a profit sharing plan, but there are limits. For example, a business with participants' compensation of $500,000 could contribute and deduct $75,000 (15% x $500,000) under existing law. The limit for profit sharing plans and stock bonus plans will be increased to 25% of aggregate compensation from

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Employers and the qualified plan industry will have one year to revise plan documents to include such new contribution rights, as these new laws will go into effect for plan years beginning after December 31, 2002.

New Taxation Rule for Certain IRA Distributions

The existing law provides the following rules for applying Code section 72 to any IRA distribution – (A) all IRAs shall be treated as one contract, (B) all distributions during any taxable year shall be treated as one distribution and (C) the value of the contract, income on the contract, and investment in the contract, shall be computed as of December 31, and the value must be adjusted by any current-year distributions.

There are new rules for applying section 72 to a distribution from an IRA which is rolled over to a qualified plan, section 403(a) plan, section 403(b) plan, or section 457 plan. They are: (1) section 72 shall be applied separately to this distribution, (2) the amount rolled over to the workplace plan shall only be the taxable portion (i.e. all earnings and all deductible contributions) of all of the recipient's IRAs, and (3) appropriate adjustments shall be made in applying section 72 to other distributions in such taxable year and subsequent years. A person's basis in his or her IRA shall not be rolled over from an IRA to a workplace plan.

Change in Method to Calculate the Maximum Deductible Amount for a 401(k) Plan.

Under the current law, if an employer has a standardized profit sharing plan, and the aggregate compensation for participants is $1,000,000, then the employer may make a maximum contribution of 15% ($150,000) to the plan. Assuming the employer contributes the full amount of 15%, he may deduct this amount as a pension expense on his business income tax return.

In contrast, if an employer has a 401(k) plan, and the aggregate compensation for participants is $1,000,000, and the total elective deferrals made by participants are $100,000, the employer may only deduct $135,000 on his tax return. The reason: elective deferrals are considered EMPLOYER contributions, and must be subtracted from compensation to figure the 15% allowable contribution. Therefore, $1,000,000 - $100,000 = $900,000. This amount times 15% equals $135,000. Also, the $100,000 of elective deferrals is <u>included</u> in this $135,000. The new law, which will be effective for years beginning after December 31, 2001 (i.e. 2002), no longer takes into consideration elective deferrals for purposes of determining an employer's deduction limit. Therefore, for 2002 and subsequent years, if the employer contributes the maximum of 15% of aggregate compensation, he will then be able to deduct the entire 15% on his income tax return.

Increase in 401(k) Elective Deferral Limit

The 401(k) elective deferral limit under Internal Revenue Code section 402(g) is $7,000, but because of COLA adjustments, the limit is $10,500 for 2001. The new law sets the limit for 2002 at $11,000. As with many of the tax law changes, there will be a gradual increase in this limit over a number of years as follows:

Year	Limit
2002	$11,000
2003	$12,000
2004	$13,000
2005	$14,000
2006 or thereafter	$15,000

This limit will be adjusted by a COLA for tax years beginning after December 31, 2006.

Similar changes have been made in the elective deferral limits for section 457 plans which apply to deferred compensation plans of state and local governments and tax exempt organizations.

For purposes of applying this elective deferral limit for a self-employed person, there will be a new definition of compensation. The term "trade or business" for purposes of section 1402 will include service as defined in section 1402(c)(6).

This change is effective for plan years beginning after December 31, 2001 (i.e. 2002).

Catch-up Contributions for Individuals Age 50 or Over

A qualified plan will be able to permit those individuals who are age 50 or over to make additional elective deferrals as follows:

Year	Additional Amount
2002	$1,000
2003	$2,000
2004	$3,000
2005	$4,000
2006 and thereafter	$5,000

Thus, the elective deferral limits for those 50 or over are:

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Year	Adjusted Amount
2002	$12,000
2003	$14,000
2004	$16,000
2005	$18,000
2006 and thereafter	$20,000

The plan will be required to allow all eligible participants to make the same election with respect to these additional elective deferrals.

This change is effective for years beginning after December 31, 2001 (ie. 2002).

New Type of Contribution – Roth Elective Deferrals

A qualified plan will be able to be written to include a new type of contribution – the Roth elective deferral. The difference is that this contribution type shall not be excludable from the participant's gross income. A participant otherwise entitled to make elective deferrals will have to determine if he or she should designate some or all of them as Roth contributions. Such a qualified plan will have to establish separate accounts (Roth accounts) for the designated Roth contributions plus any related earnings. And such plan will have to provide separate recordkeeping for Roth accounts.

The limit(s) which apply to elective deferrals for a particular participant will apply to the combined sum of a participant's elective deferrals and Roth contributions.

A participant will be able to designate as a Roth contribution any or all of his or her permissible elective deferrals.

A participant will be able to roll over any payment or distribution from a Roth account from one qualified plan to a Roth account within another qualified plan, or to a Roth IRA.

The taxation rules for a distribution from a Roth account are very similar to distributions from a Roth IRA, but there are some differences. The term "qualified distribution" has the same meaning as it does for a distribution from a Roth IRA. However, there is a different five-year period than with a Roth IRA. This special five-taxable-year period begins with the earlier of (1) the first taxable year for which the participant made a designated Roth contribution to any designated Roth account under the same plan, or, (2) the first taxable year for which the participant made a designated Roth contribution, if the participant has rolled over a Roth contribution account form another plan.

This change is effective for taxable years beginning after December 31, 2005 (i.e. 2006).

Change in the Same Desk Rule

One of the fundamental rules of 401(k) plans is that a plan cannot qualify as a 401(k) plan unless the employee's elective deferrals may not be distributed to participants and beneficiaries earlier than

1. Separation from service, death or disability,
2. Termination of the plan or other disposition of assets or subsidiary,
3. Attaining age 59 1/2 or
4. Upon the occurrence of a hardship.

For a long time, the IRS has maintained that the mere change in the ownership of a business did not necessarily result in a "separation from service" as that term had been defined by the IRS.

The new law will authorize a distribution from a 401(k) plan if there has been a severance from employment versus a mere separation from service. The concept is – if the owner has changed, then there will have been a severance of employment with the old employer and a hiring by the new employer. In this situation it will be permissible to withdraw the funds from the first employer's 401(k) plan.

This change will be effective for distributions occurring after December 31, 2001.

Relaxation of Hardship Restriction

The IRS has written a regulation which requires that a person who receives a hardship distribution from a 401(k) be prohibited from making elective deferrals for a period of 12 months. The law change stipulates that the IRS should rewrite its regulation so that the period of prohibition is only six months.

This change is effective for years beginning after December 31, 2001 (i.e. 2002).

Repeal of the Multiple Use Test

For some time, the law has provided nondiscrimination tests for elective deferrals, matching contributions, and employee contributions. There are two nondiscrimination tests, an ADP and an ACP test.

A plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ADP of the nonhighly compensated employee group for the prior plan year and not more than 2 percentage points greater

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than the ADP of the nonhighly compensated employee group for the prior plan year.

A plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the nonhighly compensated employee group for the prior plan year and not more than 2 percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

The second method available to meet the ADP and the ACP is called the alternative method. Under existing law, the alternative method cannot be used to satisfy both tests. In this situation another test was needed, the multiple use test. In the past it was thought that the ability to use the alternative method to satisfy both tests was too good a deal for the highly compensated employees (i.e. it discriminated in favor of the highly compensated employees).

In order to bring some simplification to the testing process, the alternative method will be able to be used to satisfy both the ADP and ACP tests. The effect of this change is to repeal the multiple use test.

The IRS is to write regulations to carry out this intent to repeal this prohibition to use the alternative limitation for both 401(k) and (m) purposes.

This amendment shall apply to years beginning after December 31, 2001.

Elective Deferrals and Employer Stock

A technical correction has been made with respect to The Taxpayer Relief Act of 1997. That Act added a law that prohibited the investment of elective deferrals in assets consisting of qualifying employer securities, qualifying employer real property, or both. The technical correction was to add the grandfather rule. This section does not apply to previously acquired property. Because of the technical change, employer securities or property acquired with elective deferrals before January 1, 1999, are permissible.

Increase in Section 415 Benefit and Contribution Limits

Code section 415 imposes a maximum limit on the annual benefit which a plan may pay a participant under a defined benefit plan, and on the annual contribution which an employer may make on behalf of a participant in a defined contribution plan. There was a special limit if a person was a participant under both types of plans at the same time. For a long time, the annual benefit limit was $90,000, and the annual contribution limit was $30,000. The $90,000 is subject to a COLA adjustment, and has increased to $140,000 for 2001. The $30,000 is subject to a COLA adjustment and has increased to $35,000 for 2001.

These limits have again been increased – $160,000 will replace the $140,000 limit and $40,000 will replace the $30,000 limit. In future years there will be respective cost-of-living adjustments in increments of $5,000 or $1,000, if applicable.

The $160,000 limit will be reduced if the benefits begin before age 62 and will be increased if the benefit begins after age 65. There is a special limit for commercial airline pilots.

For defined benefit plans, the change is effective for plan years ending December 31, 2001. For defined contribution plans, the change is effective for plan years beginning after December 31, 2001.

Compensation Limit Increased to $200,000

As a second way of limiting the annual benefit or the annual contribution, the law has contained a limit on the amount of compensation which will be considered for allocation and contribution purposes.

Prior to 1986, there was no limit on the amount of compensation which could be used to allocate the employer's contribution. In 1986, the initial limit was set at $200,000. At that time there was a search for additional tax dollars. In 1994, the $200,000 was reduced to $150,000, but the $150,000 was adjusted by a cost-of-living adjustment (COLA). For 2001, the adjusted limit is $170,000. Therefore, the maximum (15%) SEP or profit sharing contribution in a nonintegrated plan is $25,500 for 2001. The limit is again $200,000 for 2002 and subsequent years, and there is a COLA adjustment.

For defined contribution plans, the change is effective for plan years beginning after December 31, 2001 (i.e. 2002). For defined benefit plans, the change is effective for plan years ending after December 31, 2001.

Changes to the Top Heavy Rules

The definition of who is a key employee is changed in two ways. First, under current law, the determination is made by looking to the current year and the four preceding plan years. Only the current year will be looked at under the new law. Under the new law, an officer of the employer is a key employee if he or she has an annual compensation greater than $130,000.

Employer matching contributions will be able to be taken and will count against the top-heavy contribution requirement.

Certain prior distributions must be considered in determining whether or not a plan is top heavy. Distributions during the last

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year before the determination date shall be taken into account. Under existing law, the look-back period was five years, not just one year. The five-year period will continue to apply in the case of in-service distributions if the distribution is made for a reason other than separation from service, death, or disability.

A 401(k) plan will be deemed to not be top heavy if it uses any of the alternative methods of the nondiscrimination requirements.

The top-heavy rules will not apply to a frozen plan to the extent that no key employee or former key employee benefits (within the meaning of section 410(b)) under the plan.

This change is effective for years beginning after December 31, 2001 (i.e. 2002).

Faster Vesting Mandated for Certain Employer Matching Contributions

The standard vesting schedules will no longer apply to certain employer matching contributions. If the cliff vesting rule applies, then a person must be 100% vested after three years rather than the current law of five years. If the non-cliff rule applies, then a person must be vested at least as rapidly as set forth in the following schedule, which is a six-year schedule rather than the seven-year schedule which current law requires:

Years of Service	Vesting Percentage
1	0%
2	20%
3	40%
4	60%
5	80%
6	100%

This change is effective for years beginning after December 31, 2001 (i.e. 2002). However, it will not apply to certain collective-bargaining agreements. And such change will not apply to any participant before the date that such employee has one hour of service under such plan in any plan year to which the amendments made by this section apply.

Numerous New Rollover Rules

Even though rollovers were discussed in a previous newsletter in regard to IRAs, they also need to be discussed in regard to qualified plans, as there will be rollovers from IRAs to QPs, and from QPs to IRAs.

For some time, the discussion in Washington, D.C. has been to increase a person's ability to move funds from a retirement plan as sponsored by one employer to a different retirement plan as sponsored by a different employer. The law has now been written to authorize such portability, but, as will be seen, these rules certainly will add complexity to the administration of retirement plans.

Change #1 - Rollovers From Section 457 plans.

Under existing law, it is impossible to roll over funds from a section 457 plan to any other type of retirement plan, including another section 457 plan. This would change under EGTRRA 2001.

There will now be rollover provisions which are very similar to those which apply to qualified plans. If any portion is paid from the plan to an employee in an eligible rollover distribution (any distribution except those based on an employee's life or life expectancy, for a period of 10 years or more, any required distribution and any hardship distribution), the employee transfers any portion of the property to an eligible retirement plan (an IRA under section 408(a) or (b), a qualified trust under section 401(a) or a section 403(a) annuity), and in the case of a distribution of property other than money, the amount so transferred consists of the property distributed, then such distribution (to the extent so transferred) shall not be includible in the recipient's gross income. The other rules of Code section 402(c) shall also apply, including the right of a surviving spouse to roll over their deceased spouse's account balance.

The plan administrator of the section 457 plan will be required to furnish the recipient the section 402(f) notice, a written explanation of the plan provisions – (i) under which the recipient may have the distribution directly rolled over (transferred) to an eligible retirement plan, (ii) which require the withholding of income tax if it is not directly transferred, (iii) under which the distribution will not be subject to tax if transferred to an eligible retirement plan within 60 days after the date on which the recipient received the distribution, and (iv) of the 10-year averaging rules, if applicable.

Rollovers will be reported in the same manner as rollovers from qualified retirement plans.

The plan must be written to comply with and contain the direct rollover provisions or rules.

Change #2 - Rollovers To a Section 457 plan from a Section 401(a) Plan, IRA, or 403(b) Plan.

The definition of "eligible retirement plan" will be changed to include a section 457(b) plan which is maintained by an eligible employer. The section 457 (b) plan must agree (i.e. must be written) to separately account for amounts rolled from any eligible retirement plan other than another section 457(b) plan. Funds may now be rolled over from an IRA to a section 457 plan, since an IRA is an eligible retirement plan.

There is a special rule for certain rollovers to section 457 plans. This could be called the "conduit 457" rule. If the funds

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in the section 457 plan were originally rolled into the section 457 plan from a qualified retirement plan as defined in section 4974(c) as follows: (i) a section 401(a) qualified plan; (ii) a section 403(a) annuity; and (iii) a section 403(b) annuity; (iv) a section 408(a) IRA and a section 408(b) IRA annuity, then a distribution from the 457(b) plan shall be treated as a distribution from that specific type of plan.

Change #3 - Rollovers From Section 403(b) plans.

Current law provides that funds distributed from a section 403(b) plan may be rolled over to another 403(b) plan, an IRA, or an IRA annuity.

The revised law will provide that distributions from a 403(b) plan may be rolled over into an eligible retirement plan which is now defined to be any of the following: (an IRA under section 408(a) or (b), a qualified trust under section 401(a), a section 403(a) annuity, or a section 457 plan).

Change #4 - Rollovers To a Section 403(b) plan from a Section 401(a) Plan, IRA or 457 Plan.

The definition of eligible retirement plan will be changed to include a section 457(b) plan in addition to a qualified plan and an IRA. A distribution from any such plan is eligible to be rolled over to a section 403(b) annuity. CWF Observation. The law uses the word "annuity contract." It does not expressly mention a 403(b) mutual fund account. A technical correction may be necessary.

Change #5 - Expand Spousal Rollovers

Under existing law, a spouse beneficiary of a participant of a qualified plan or a 403(b) plan could only roll over a distribution from such plan to an IRA or IRA annuity. That is, the spouse beneficiary could not roll over such qualified plan funds to another qualified plan or section 403(b) plan. The revised law will provide that a spouse beneficiary may roll over the inherited qualified plan funds to any eligible retirement plan – another qualified plan, a section 457 plan, a 403(b) plan, an IRA, or an IRA annuity. The spouse is treated as if he or she was the participant for these rollover rules.

Change #6 - Expand the Contents of the Section 402(f) Notice.

The reason the plan which receives the roll over must, when necessary, set up a separate account for the amount being rolled over, is that the way the distribution of such funds will be taxed will depend primarily on the original source of the funds (qualified plan, 403(b), 457 or IRA) and not on the plan from which the distribution is eventually made. The exception is – funds distributed from an IRA are subject solely to the taxation rules which apply to IRA distributions.

The revised law requires that the section 402(f) notice be modified to discuss these special tax consequences. The plan must explain the tax consequences of each separate account which is distributed.

The revised law also provides that a penalty shall not be imposed on the plan for its failure to provide this updated notice before the date that is 90 days after the date on which the IRS issues a revised section 402(f) safe harbor notice which takes into account the IRS regulation.

Change #7 – Rollovers of Traditional IRAs into Workplace Retirement Plans

The new rollover rules for a distribution from an IRA will be as follows:

1. The entire amount distributed (including money and any other property) must be contributed to the participant's IRA or IRA annuity on or before the 60th day after the day on which he receives it, or
2. The entire amount distributed to the individual (including money and any other property) must be contributed to an eligible retirement plan for the benefit of the individual on or before the 60th day after the day on which he receives it, except that it is not permissible to contribute any portion of the distribution which is not includible in the individual's gross income (i.e. which was a non-deductible contribution). For this purpose, eligible retirement plan means a qualified plan, a section 403(a) annuity, a section 403(b) plan, and a section 457 plan.

CWF Observations.

1. Any IRA may now be a conduit IRA. The law is not totally clear on whether or not funds rolled into an IRA from a certain type of workplace plan (i.e. qualified plan, 403(b) plan, or 457 plan), and then rolled back into the same type of plan or another type of workplace plan, retain their original status. It appears this will be the result.
2. Note that the restriction on rolling over nondeductible contributions applies to rollovers into a workplace plan and not into an IRA. This creates an easy way for people with nondeductible contributions to get such basis out of their IRAs. An individual can roll over the amount which is subject to taxation into a workplace plan. The nondeductible portion then remains in the plan and could, presumably, be withdrawn tax free.

These rules apply to distributions occurring after December 31, 2001.

Change #8 – Special Restriction on Rollovers from a SIMPLE

The revised law reads as follows, "(G) SIMPLE RETIREMENT ACCOUNTS - In the case of any payment or distribution out of a SIMPLE retirement account (as defined in subsection (p) to which section 72(t)(6) applies, this paragraph shall not apply unless such payment or distribution is paid into another SIMPLE retirement account."

CWF Comment. The IRS has argued for some time that Code section 72(t)(6) imposes a two-year waiting requirement before one is eligible to roll over or transfer SIMPLE funds to any type

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of plan (including an IRA) other than another SIMPLE plan, regardless of whether or not the individual satisfies one of the other exceptions to Code section 72(t). This author has never agreed with the IRS' position. The IRS must have sought this technical correction so that their argument would be strengthened. This author still thinks the IRS' position is incorrect, but the IRS' position should be followed.

These rules apply to distributions occurring after December 31, 2001.

Change #9 – Rollovers of After-Tax Contributions

Existing law does not permit any nondeductible contributions which are distributed from a qualified plan to be rolled over.

The new law will permit the rollover of such nondeductible contributions in two situations.

First, these nondeductible contributions may be rolled over to an IRA or an IRA annuity.

Second, these nondeductible contributions may be rolled over to a defined contribution plan which agrees to separately account for the amount rolled over in two ways. The receiving plan must account for that portion which will be includible in income when distributed (plus related earnings) and the portion which will not be includible in income (i.e. the nondeductible contribution amount).

Change #10 – Hardship Exception to 60-Day Rule

For a long time, the IRS has stated their belief that the law does not grant it the authority to waive or create an exception to the 60-day requirement in order to have a rollover (i.e. a distribution which is not presently taxed). It simply did not matter if the accountholder was totally faultless for missing the 60-day requirement. For example, a person asks an IRA custodian if he or she has 60 or 90 days to complete a rollover, and the IRA personnel mistakenly says 90 days.

The new law will grant the Secretary of the Treasury the discretion to waive the 60-day requirement in case of hardship – "where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement."

Change #11 – Employers and Plan Administrators May Disregard Rollovers for Purposes of Cash-Out Limits

To ease the administrative burdens, the law presently provides that if a participant's vested benefit does not, and has never, exceeded $5,000, then the plan may pay such benefit immediately, without the participant's consent.

Now that the law has been changed to make it quite easy to roll over funds from one qualified plan to another qualified plan, employers and plan administrators still wanted to be able to make an immediate distribution to a participant who had not been with the employer for too long a period of time. Thus, this law was added which provides that, for purposes of the $5,000 immediate payout rule, any funds rolled into the plan may be disregarded.

This rule applies to distributions occurring after December 31, 2001.

Change #12 – Automatic Rollover of Certain Mandatory Distributions.

Apparently qualified plan administrators incur some problems with the direct rollover rules. The apparent purpose of this provision is to give the plan administrator a very clear course of action when the participant fails to elect either to be paid or to have a direct rollover. The rule will be (if the plan is so written), if the distribution amount exceeds $1,000, and the participant fails to instruct to have a direct rollover or to take a distribution, then the plan administrator shall transfer such balance to an IRA of a designated IRA custodian or trustee. The plan administrator shall notify the participant in writing that this automatic transfer may take place. Such notice shall be able to be included in the section 402(f) notice, or separately.

For purposes of ERISA section 404(c), the participant will be treated as exercising control over the assets in the IRA upon the earlier of – a rollover of all or a portion of the amount to another IRA, one year after the transfer is made, or if the transfer is made in a manner consistent with the governing IRS regulation.

The Department of Labor shall, by regulation, provide for automatic rollover safe harbors under which the designation of the IRA custodian/trustee is deemed to satisfy the fiduciary requirements of section 404(a) of ERISA. The deadline for this regulation is no later than 3 years after the date of enactment (June 7, 2001).

These amendments will not apply to any distributions until after the final regulations are issued.

Special Taxation Rule for Certain Rollovers When Distributed from Certain Workplace Plans

The Tax Reform Act of 1986 contained some very important rule changes which affected distributions from a qualified plan. There were two special rules created by TRA 86 which need to be understood before one can understand why there was a need for a special taxation rule.

Section 1122(h)(3) of TRA86 provided the first special rule for individuals who attained age 50 before January 1, 1986 (i.e. born before January 1, 1936). The rule – the person could use the then existing (and special) capital gains rules (as of 1986) for a lump-sum distribution.

Section 1122(h)(5) of TRA86 provided the second special rule for individuals who attained age 50 before January 1, 1986 (i.e.

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born before January 1, 1936). The rule – the person could use 10-year averaging for certain lump-sum distributions. The tax rate to be used was the 1986 tax rate.

After numerous law changes, these special rules still apply to those born before January 1, 1936, as they have been grandfathered.

The concept and effect of the current special rule is – if a taxpayer has only been able to roll over funds into a qualified plan because of the new rollover rules (e.g. from a section 457 plan, section 403(b) plan, or IRA), then he or she will not be entitled to use the special 10-year averaging and/or capital gain rules with respect to these funds.

If the person was otherwise eligible to roll over such earlier funds into a qualified plan, then he or she will be able to use 10-year averaging/capital gain with respect to such funds, assuming all other requirements for 10-year averaging/capital gain have been satisfied.

Partial Relaxation of Loan Restrictions

Subchapter S Owners, Partners, Sole Proprietors, and Controlling Shareholders

The general rule is that a loan by a qualified plan to a participant is a prohibited transaction. The law for some time has provided an exemption for certain employees, but the law has not allowed such loans to be made to Subchapter S owners, partners, and sole proprietors. The law will now provide that a plan may loan funds to a shareholder employee of a Subchapter S corporation.

The law will still prohibit a qualified plan from making a loan to sole proprietors, partners, and any person who owns 50% or more of the sponsoring corporation.

This change is effective for plan years beginning after December 31, 2001 (i.e. 2002).

Cafeteria Plans and Employer-Provided Retirement Advice

Cafeteria plans will be able to be written to include the providing of qualified retirement planning services. If certain rules are followed, the providing of such services will not need to be included in a recipient's gross income.

This amendment shall apply to years beginning after December 31, 2001.

Credit for Small Employer Pension Plan Startup Costs

An eligible employer shall be entitled to a credit equal to 50% of its qualified start-up costs with respect to establishing a new retirement plan. This credit is available for the first three years. The annual credit may not exceed $500. The term "qualified start-up costs" means any ordinary and necessary expenses related to the establishment or administration of the plan, or retirement-related education of the employees. This credit is not available to one-person plans.

Elimination of User Fees for Requests to IRS Regarding Pension Plans

The IRS will not be able to charge user fees for requests to the IRS for determination letters with respect to the qualified plan status. This no-fee rule will not apply to any request made after the later of– the fifth plan year the plan is in existence, or the end of any remedial amendment period which begins within five years of when the plan started. This no-fee rule will also not apply to any request made by a sponsor of a prototype plan which the sponsor intends to market to participating employers.

This change is effective for requests made after December 31, 2001 (ie. 2002).

New Life-Expectancy Tables Mandated

The Law mandates that the IRS shall change the life-expectancy tables which are used to calculate required minimum distributions to reflect current life expectancy. However, the law does not set a deadline for the IRS.

Medical Savings Account Update

MSAs (other than Medicare+Choice MSAs) have been renamed "Archer MSAs." Also, the pilot project for Archer MSAs which was scheduled to end December 31, 2000, has now been extended to December 31, 2002.

Enclosed as an insert to this newsletter is the IRS Form 8851 for 2001. If you are the custodian/trustee of an Archer MSA, you must file Form 8851. This form must be filed by August 1, 2001, to report Archer MSAs established for 2001, from January 1, 2001 through June 30, 2001.◆

Increase in Deduction, Continued from page 1

the existing 15%. Under the above example, the business will be able to contribute and deduct $125,000 (25% x $500,000).

This limit will also apply to money purchase plans and other plans subject to the funding standards of section 412, unless the Secretary provides otherwise.

The definition of compensation shall include amounts treated as participants' compensation under subparagraphs (C) or (D) of section 415(c)(3).

This change is effective for years beginning after December 31, 2001 (i.e. 2002).◆