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New Tax Law: Benefit Plan Sponsors Have New Choices and Obligations

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On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16, the "Act"), implementing the most significant changes to the tax laws affecting retirement plans in the past 15 years. Employees will benefit from opportunities for increased savings and greater portability between different retirement vehicles. Employers will have greater flexibility in designing plans, but they will be subject to new requirements, such as increased disclosure obligations for amendments that reduce future pension benefits and new notice requirements on distribution options.

Most of the provisions take effect January 1, 2002, although some changes are delayed until later years. All of the provisions are set to expire on December 31, 2010, absent further Congressional action.

Highlighted below are provisions of the Act that will affect employee benefit plans offered by private sector employers and governmental and tax-exempt organizations, as well as individual retirement accounts (IRAs).

Defined Contribution Plans: Higher Limits, Faster Vesting and Greater Portability

Described below are some of the most significant changes that affect 401(k) plans and other qualified defined contribution plans. Changes specifically affecting 457 deferred compensation plans and 403(b) annuity plans maintained by governmental and tax-exempt organizations are discussed under "*Tax Exempt Organizations and Governmental Plan Sponsors: New Planning Opportunities.*"

- Maximum annual elective deferral contributions to a 401(k) plan increases to \$11,000 in 2002, increasing in \$1,000 annual increments to \$15,000 by 2006 (then indexed for inflation in \$500 increments in later years).

- Maximum annual allocations (including both employer and employee contributions) increase to the lesser of \$40,000 or 100% of compensation (indexed for inflation in \$1,000 increments).
- The compensation limit for purposes of determining plan contributions and benefits increases to \$200,000 (indexed for inflation in \$5,000 increments).

Impending August 7, 2001 Change to Backup Withholding Rate, by Brian Wainwright and James T. Chudy, follows on [page 4](#) of this bulletin.

- 401(k) plans may permit participants over the age of 50 to make additional "catch-up" contributions of \$1,000 in 2002, increasing to \$5,000 by 2006. If this option is offered to any group of employees, it must be offered to all eligible employees under all 401(k) plans maintained by the same or an affiliated employer.
- Employer matching contributions must vest at least as fast as 100% after three years of service, or 20% after two years of service and 20% per year thereafter, with 100% vesting after six years of service.
- Participants in 401(k) plans, governmental 457 plans, and 403(b) annuities can roll over distribution amounts between plans or to an IRA. After-tax contributions may also be rolled over to an IRA or to another qualified plan that can properly account for such contributions. This will require changes in notices provided to participants when distributions are made from these plans.
- Employees who continue in the same job for a successor employer after a sale of the business may

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receive distributions from 401(k) plans. The “same desk” rule that formerly prohibited a distribution in this situation has been repealed and there is now deemed to be a “severance from employment” that permits a distribution unless all or a portion of the 401(k) plan is assumed by the successor employer.

- The Act makes it easier for sponsors of defined contribution plans to remove unwanted forms of benefit payments without violating “anti-cutback” rules.
- The annual limit on an employer’s tax deduction for contributions to a qualified defined contribution plan is increased to 25% of the aggregate compensation of plan participants. In addition, elective deferrals are now deductible without limit.
- Beginning in 2003, employers may permit employees to have “deemed IRAs” under a qualified defined contribution plan. This will allow employees to contribute money under a plan outside of 401(k) limits, but subject to IRA limits. Similarly, beginning in 2006, employers may permit employees to designate elective deferrals as Roth IRA contributions, which would be taxed at the time of deferral but not at distribution.
- After the U.S. Department of Labor issues appropriate regulations (within three years after the enactment of the Act), plans must provide that any mandatory cash-out distribution exceeding \$1,000 be rolled over into an IRA.
- Hardship withdrawals from defined contribution plans (including hardship withdrawals of employer matching contributions as well as elective deferral amounts) will not be eligible for rollover. In addition, under the “safe harbor” rules for hardship withdrawals from 401(k) plans, the period after a hardship withdrawal during which employee contributions are prohibited is reduced to six months.
- The “multiple use” test affecting highly compensated participants in 401(k) plans has been repealed.

Defined Benefit Plans: Higher Limits and Increased Disclosure

Defined benefit plan sponsors will need to amend their plans to reflect increased benefit limits and provide increased disclosure to participants in the event of

reductions of future benefit accruals. Plan sponsors will also be able to take advantage of increased deduction limits for qualified plan contributions.

- As is the case for qualified defined contribution plans, the compensation limit for purposes of determining qualified defined benefit plan benefits is increased to \$200,000 (indexed for inflation in \$5,000 increments).
- For limitation years ending after December 31, 2001, the maximum annual benefit payable from a qualified defined benefit plan is increased to \$160,000 (indexed for inflation in \$5,000 increments). Note that for defined benefit plans with non-calendar limitation years, the increased dollar limit is effective immediately. This limit is reduced if benefit payments begin before age 62, and increased if payments begin after age 65. As under prior law, the annual benefit can never exceed 100% of the participant’s average compensation for his or her highest three years.
- Tax deduction limits on funding are significantly relaxed. The current liability full funding limit is increased to 165% of current liability in 2002, 170% in 2003, and repealed entirely in 2004. Contributions made to fully fund terminating plans will be fully deductible.
- Effective immediately, increased disclosure to participants is required in the event of a significant reduction in future benefit accruals in a defined benefit or money purchase pension plan, including the elimination or significant reduction of early retirement benefits or similar subsidies. This notice must include sufficient information to describe to participants the effect of the amendment. The notice must be given within a reasonable time before the reduction takes effect, and may be sent prior to adoption of the amendment modifying the benefit so long as no material changes are made after the notice is given. Violations are subject to a penalty of \$100 per day per participant. Egregious violations could invalidate the desired reduction in benefits.

Tax Exempt Organizations and Governmental Plan Sponsors: New Planning Opportunities

Beginning in 2002, participants in 403(b) annuity plans and 457 deferred compensation plans will be given many of the same contribution opportunities as

participants in 401(k) plans. In addition, the Act provides a number of new planning opportunities for sponsors of these plans.

- 403(b) annuity plans and 457 deferred compensation plans will be permitted to allow elective deferral contributions up to the same limits as 401(k) plans: \$11,000 in 2002, increasing in \$1,000 annual increments to \$15,000 by 2006 (indexed for inflation in later years).
- Like 401(k) plans, 403(b) plans and governmental 457 plans can allow participants over age 50 to make additional “catch up” contributions up to \$1,000 in 2002, increasing to \$5,000 by 2006. In lieu of “catch up” contributions, participants in all 457 plans who are in their last three years before normal retirement age may be allowed to contribute up to two times the otherwise applicable annual elective deferral limit up to \$22,000 in 2002, increasing to \$30,000 by 2006 (indexed for inflation in later years).
- Participants in governmental 457 plans, 403(b) plans and 401(k) plans will be able to roll over distributions between plans or to an IRA.
- Sponsors of 403(b) plans and 457 plans will be able to permit trustee-to-trustee transfers for the purchase of permissive service credit under governmental defined benefit pension plans.
- Elective deferral contributions made under a 457 plan will no longer be reduced by elective deferrals made by the participant under other plans sponsored by the same employer. This means, for example, that an employee who participates in both a 457 plan and a 403(b) plan may elect to defer up to \$22,000 in 2002.
- Participants in governmental 457 plans will no longer be taxed when amounts are “made available” to them; instead, amounts will be taxed when actually paid (and taxation can be further delayed if the amounts are rolled over to an IRA or to another eligible plan).

Individual Retirement Accounts: Higher Limits and Greater Flexibility

Individuals with IRAs will benefit from being able to contribute greater amounts to their accounts and from the ability to roll over account balances to and from other qualified plans or IRAs.

- The annual limit on contributions to an IRA is increased to \$3,000 for the years 2002 through 2004, \$4,000 for the years 2005 through 2007, and \$5,000 for 2008 and later years.
- Individuals over the age of 50 may make additional catch-up contributions of \$500 for years 2002 through 2005 and \$1,000 for 2006 and thereafter.
- Amounts distributed from an IRA may be rolled over into a 401(k) plan, governmental 457 plan, or 403(b) annuity. As discussed above, IRAs will be able to receive rollover contributions from these other plans, including rollovers of after-tax contributions.

Plan Sponsors Should Begin Considering New Options and Taking Steps to Comply With New Requirements

Because most of the new changes are effective January 1, 2002, employee benefit plan sponsors should begin considering changes they might want to implement. Plan sponsors should also begin taking steps to comply with new obligations, such as additional disclosure in the event of a benefit reduction and revised distribution notices.

Materials Available On-Line

Readers who are using Acrobat Reader 3.0 or later (or an Acrobat 3.0 or later-enabled web browser) to review this bulletin can obtain the referenced legislative materials through the links in the ensuing list. Alternatively, the html version of this article at www.pmstax.com/gen/pension0107.shtml contains links to the material.

- [P.L. 107-16, Table of Contents and Title VI](#) (Pension and Individual Retirement Arrangement Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001) [204K]
- [H.Rpt. 107-84, pp. 115-120, 205-306](#) (Joint Explanatory Statement of the Committee of Conference, Table of Contents and Title VI, Pension and Individual Retirement Arrangement Provisions) [327K]



Impending August 7, 2001 Change to Backup Withholding Rate

Brian Wainwright • James T. Chudy

As part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16, the "Act"), signed by President Bush on June 7, 2001, the rate applicable under the backup withholding regime has been conformed to the staged reduction in general income tax rates.

Section 101(c)(10) of the Act revises Internal Revenue Code section 3406(a) to change the backup withholding rate from 31 percent to "the fourth lowest rate of tax applicable under [Internal Revenue Code] section 1(c)."

Following the rate reduction amendments of Section 101(a) of the Act, that fourth lowest rate of tax (because

of introduction of the new 10 percent bracket) and, accordingly, the backup withholding rate will be as follows for the listed years:

2001	30.5%
2002-2003	30%
2004-2005	29%
2006-	28%

Section 101(d)(2) of the Act provides that the change to the backup withholding rate is effective after the 60th day after the date of enactment of the Act, June 7, 2001. The 60th day after June 7, 2001 is August 6, 2001. Thus, the 30.5 percent backup withholding rate will apply to payments on or after August 7, 2001 and will decline on January 1, 2002 in accordance with the foregoing schedule.

In **Announcement 2001-80**, the Internal Revenue Service confirmed the 30.5 and 30 percent rates and also listed its forms and publications affected by the new rates.

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