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The New Tax Law: Focus on Employee Benefits

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Abstract: *The Economic Growth and Tax Relief Reconciliation Act of 2001 is the most significant tax legislation since 1981. More than half of the provisions within the new law affect employee benefits. This article focuses on the employee benefit aspects of the new tax law and outlines planning opportunities for employers.*

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Introduction

The Economic Growth and Tax Relief Reconciliation Act of 2001 is the most significant tax legislation since 1981. New opportunities for businesses have emerged as a result of the act. The triad of the new tax law, existing federal law called GUST[1], and the struggling economy represents not only numerous challenges for American businesses but also a tremendous opportunity to retool their compensation and benefit plans to more effectively achieve organizational goals.

Today, successful enterprises must balance the workforce demands associated with finding and keeping quality talent with managing the ever-increasing cost and liability of running a business. Because of IRS deadlines imposed by GUST and the numerous provisions of the new tax law, time is of the essence to review, design, and update qualified retirement plans. Over half of the provisions of the new law affect employee benefit plans. Included in the myriad of provisions are:

- new tax rates and increases in contribution limits
- new types of contributions
- tax incentives for retirement plans
- new rules for distributions, loans, and rollovers
- reduced regulatory burdens
- enhanced education benefits
- tax credits for on-site child-care facilities

Furthermore, under existing legislation, most qualified retirement plans must be restated, or totally rewritten, by Feb. 28, 2002, to comply with federal law.

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Synopsis of New Tax Law's Effect on Employee Benefits

President Bush and Congress had the same goals for the new tax law—to provide tax relief and to expand retirement savings and educational opportunities for working Americans. The methods to accomplish these goals are lower tax rates, expanded contribution limits, increased portability of retirement plans, relaxed regulations, and new educational savings opportunities.

Retirement Plan Changes

The law's retirement plan reforms

- increase the amount of contributions that may be added to most retirement plans
- increase to $200,000 the annual limit on compensation that may be considered for most retirement plans
- create faster vesting schedules for employer-matching contributions
- increase the defined-benefit annual limit to $160,000
- increase the maximum amount that may be contributed to most retirement plans to 100 percent of compensation up to $40,000
- require additional notices for plan sponsors that reduce plan benefits
- allow employees age 50 and older to add additional amounts to retirement plans to catch up
- create new rollover possibilities from different types of retirement plans to other plans
- streamline distributions from retirement plans
- clarify that employer-provided retirement planning advice is nontaxable to employees
- allow corporate deductibility of certain dividends on employee stock ownership plan (ESOP) stock for plan participants
- remove employee elective deferrals from employer's deduction limit

Executive Retirement Benefits

Although the tax law creates the opportunity for highly compensated employees to contribute additional amounts to qualified plans, the actual amount that may be contributed to a 401(k) plan will continue to be determined by the average contributions of lower-paid employees.

Thus, strategies designed to increase the overall participation level of non-highly compensated employees will become increasingly important to allow the highly compensated to take advantage of the increased limits in 401(k) plans. In addition, because of the difficulty in passing nondiscrimination tests and with future lower tax rates on the horizon, nonqualified deferred-compensation plans will undoubtedly increase in popularity.

Education Incentives

The new tax law provides incentives designed to encourage employers and employees to pursue education. Graduate courses will become eligible for reimbursement under Section 127 education plans and the deductible limit on education expenses will increase to $5,250 in January 2002.

In addition, employees may contribute four times more to Section 529 educational savings plans. The contribution limits on education IRAs have also been enhanced. The contribution to education IRAs is increased from $500 to $2,000 a year. Section 529 plans do not have a contribution limit.

New Tax Rates and Increases in Contribution Limits

Individual rate reductions are the hallmark of the new legislation and are summarized in Table 1.

The future tax rates create an incentive for deferred-compensation programs, stock options, and other compensation strategies that transfer income to future years at lower tax rates. Both nonqualified and qualified retire-

TABLE 1

Year	Marginal Tax Rate Brackets					
2000		15%	28%	31%	36%	39.6%
2001	Rebate	15%	27.5%	30.5%	35.5%	39.1%
2002-2003	10%	15%	27%	30%	35%	38.6%
2004-2005	10%	15%	26%	29%	34%	37.6%
2006-2010	10%	15%	25%	28%	33%	35%

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ment plans are more attractive because of the lower rates.

One of the most significant opportunities arising out of the new tax law is the ability to contribute additional dollars in most qualified retirement plans on a pretax basis.

In fact, one of the primary intents of the law is clearly to provide incentives and opportunities for greater retirement savings in America. America has one of the lowest individual savings rates in the world. In addition, the long-term outlook for the Social Security system is tenuous at best. Congress and the President recognize that increased participation in employer-sponsored and private retirement plans will ease some of the pressure on the government to provide retirement income.

Increased Employee Deferral Amounts

The new law increases the general contribution limit to 401(k) and 403(b) plans as shown in Table 2.

TABLE 2

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

The new limits are favorable for employees, but the employer should consider the effect on the actual deferral percentage testing to determine whether highly compensated employees will be able to take full advantage of the increased limits.

The increased limits are significant, but qualified plans must comply with more than 30 different requirements to maintain their preferential tax treatment.

Increased SIMPLE Limits

Current law enables employees to defer up to $6,000 in savings-incentive match plans for employees (SIMPLE plans). Only an employer that had no more than 100 employees who earned $5,000 or more in compensation during the preceding calendar year can establish a SIMPLE plan. Under the new law, the maximum deferral limit is as shown in Table 3.

TABLE 3

Year	Deferral Limit
2002	$7,000
2003	$8,000
2004	$9,000
2005	$10,000

The increased deferral limits to SIMPLE plans make them a cost-effective alternative to traditional plans for small employers.

Increased Annual Limit for Defined-Contribution Plans

Under current law, an individual's maximum contribution to defined-contribution plans is limited to the lesser of $35,000 or 25 percent of compensation. The new law changes the $35,000 limit to $40,000 (adjusted for inflation in $1,000 increments).

One of the most advantageous aspects of the new provision, however, is that an employee may defer 100 percent of compensation up to the dollar-amount limit beginning for plan years after Dec. 31, 2001. This change should allow increased contributions for all employees.

In addition, this change eliminates a formerly complicated calculation and is easier to explain to employees. The limit now also applies to 403(b) and simplified employee pension (SEP) plans.

Observation: Couples who both work may now be able to save significantly more in retirement plans than before. In addition, employers may now increase tax-deductible profit-sharing contributions from 15 percent to 25 percent.

Table 4 provides an example of this reform.

Increased Deduction Limit for Defined-Contribution Plans

Under current law, employees can defer 25 percent of compensation, up to $35,000, into a defined-contribution

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TABLE 4

	Current Law	New Law
Employee 401(k) contribution	$10,500	$11,000
Employer match	$600	$600
Profit-sharing contribution	$800	$800
Possible account additions	$11,900	$12,400
Percentage of pay limitations	25%	100%
Dollar equivalent	$5,000	$20,000
Allowable additions	$5,000	$12,400
As a percentage of pay	25%	62%

Assumptions: An employee with earnings of $20,000 contributing to a 401(k) plan with employer match of 50 cents per dollar up to 6 percent of pay and 4 percent profit-sharing contribution

plan. The employer, however, can deduct only 15 percent of compensation for most defined-contribution plans.

This essentially means that when employer and employee contributions are added together, the aggregate may not be more than 15 percent. The net result limited some employers from contributing the maximum amount to the plan.

With the new law, however, this limit no longer includes employee elective deferrals and is increased to 25 percent of "gross" compensation beginning in January 2002, allowing a much greater deferral into defined-contribution plans. This limit also applies to SEP plans.

Observation: Employers who may have used multiple retirement plans to achieve the maximum contribution level for employees may now be able to achieve the same objective with one plan. The need for money-purchase plans may be eliminated after 2001 and there may be an increased interest in age-weighted and new comparability plans.

Increased Compensation Limit for Qualified Plans

The new law changes the amount of compensation that can be used to determine benefits from $150,000 ($170,000 as indexed for inflation) to $200,000. The new limit will also be adjusted for inflation in $5,000 (rather than $10,000) increments beginning in January 2002.

This is a déjà vu change because the limit was formerly $200,000 and now returns to that amount. This limit allows for higher possible contributions. Some employers have created additional nonqualified supplemental employee retirement plans (SERPs) and excess benefit plans to correct reverse discrimination and/or to make provision for additional contributions on behalf of highly compensated employees. If these objectives may be obtained within the new expanded limits of qualified plans, then maintaining nonqualified supplemental plans may no longer be necessary.

403(b) Plan Exclusion Allowance Eliminated

The exclusion allowance for 403(b) annuities will be repealed after 2001. According to Congress, conforming the contribution limits for 403(b) annuities to the limits applicable to other retirement plans will simplify the administration of the pension laws and provide more equitable treatment for participants in similar types of plans.

Because the treatment of 403(b) annuities and other defined-contribution plans will be equalized after 2001, the special irrevocable election available to employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches to increase the amount of the otherwise permitted contributions is repealed.

Increased 457 Plan Limits

457 plans for certain tax-exempt and governmental plans will have new limits as well. Currently, 457(b) plan limits were the lesser of $8,500 or 33 1/3 percent of compensation, indexed for inflation.

Amounts deferred under a 401(k) and/or 403(b) plan counted against this limit. Limits under the new law will be the lesser of the "applicable dollar amount" or 100 percent of compensation. Table 5 shows the applicable dollar amounts.

Amounts for years beginning after Dec. 31, 2001, deferred under a 401(k) and/or 403(b) plan do not count against the 457 limit. These new provisions make 457 plans more attractive for eligible employers. Repeal of the coordination between the 401(k) and/or 403(b) and

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TABLE 5	
Year	Applicable Dollar Amount
2002	$11,000
2003	$12,000
2004	$13,000
2005	$14,000
2006	$15,000

457 amounts gives 457-eligible employers more design options. The annual limit on deferrals remains, however, and provides an overall cap on deferrals.

Increased Annual Limit for Defined-Benefit Plans

Currently, the annual contribution limit for defined-benefit plans has been related in part to a $90,000 limit, adjusted by age in some plan design calculations. The new law increases this amount to $160,000 and will adjust for inflation in $5,000 increments.

In addition, adjustments at Social Security retirement age are made for age 62 or after age 65. These provisions take effect for years ending after Dec. 31, 2001.

Because of these changes, larger contributions may be made to defined-benefit plans, making them increasingly attractive for certain owners of closely held businesses.

The new law makes retirement plans more attractive for employees and, in some cases, for employers as well. The ability to add greater contributions to plans, however, may increase funding and administrative costs of plans. A plan design analysis will help employers understand the effect of the new law on their plans and, if needed, lead to a redesign of the plan with provisions tailored to meet the employer's goals and objectives.

Observation: Large corporations historically have used defined-benefit plans. Because of the new tax law, however, owners of closely held corporations may wish to evaluate whether a defined-benefit plan can create a significant new income-tax shelter. Many complex issues surround the application of the 415 limit changes to both current and future retirees.

Table 6 illustrates an example of the dollar amount

TABLE 6	
Assumes Funding for 10 Years	
Participant Age	Maximum Contribution
45	$112,605
50	$143,716
55	$146,723
60	$187,260

Source: Rosenfeld-Tortu, Inc. White Plains, NY

that may be contributed to defined-benefit plans on behalf of participants at various ages, given the new limits.

Relaxed Vesting

Matching contributions must now vest either under a three-year cliff or a six-year graduated schedule. This provision is generally effective for years beginning after Dec. 31, 2001. This feature, while favorable to employees, may increase the payout of retirement plan dollars for employees who depart in three to six years from their date of hire.

New Types of Contributions

Catch-Up Provisions for Individuals over 50

Prior to the new tax law, all individuals were subject to the same limits. Under the new law, for those age 50 or older before the close of the plan year, the maximum additional elective deferral for 401(k), 403(b), 457, and

TABLE 7			
Maximum Deferral for Age 50 and Older			
401(k), 403(b), 457 & SEPs		SIMPLE Plans	
Year	Additional Deferral	Year	Additional Deferral
2002	$1,000	2002	$500
2003	$2,000	2002	$1,000
2004	$3,000	2002	$1,500
2005	$4,000	2002	$2,000
2006	$5,000	2002	$2,500

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SEP plans is increased as shown in Table 7.

Maximum amounts will be adjusted for inflation. Plans are not required to make the catch-up provisions available to employees. Some employers may choose not to expand their plans to allow for catching up because of the additional administrative cost to track contributions and eligibility based on age, but significant relief from nondiscrimination testing and contribution limits is provided.

Observation: Many of the provisions of the new tax law offer advantages to employees but administrative complexity for employers. The catch-up provision will require plans to perform additional record-keeping tasks and may require additional cost. Furthermore, employers will need to give special attention to communicating the catch-up provisions to employees over age 50. Employers are not required to offer catch-up provisions to employees.

New IRA Feature of Qualified Plans

A qualified plan may allow an employee to make contributions to a separate account or annuity established under the plan. If the account meets the requirements of either a traditional or Roth IRA, it will be "deemed" an IRA and not a qualified plan.

This feature takes effect for plan years beginning after Dec. 31, 2001. This provision allows employers to help employees save more inside a retirement vehicle. These IRAs will be subject to ERISA exclusive benefit and fiduciary rules, but not the reporting, disclosure, and several other ERISA requirements.

New Roth Feature for 401(k) and 403(b) Plans

Another new provision of the tax law is the addition of after-tax Roth accounts for 401(k) and 403(b) plans. These plans will not be effective until 2006. The employee will be taxed on contributions made to the Roth portion of his or her plan, but will not be taxed on future "qualified distributions" (including earnings) from the Roth account.

The total of an employee's Roth elective deferrals, plus "regular" elective deferrals, may not exceed the new elective deferral limits discussed above.

The concept of a Roth account is very powerful. In a traditional 401(k) or 403(b), an employee shelters his or her contribution from taxation currently but ultimately pays tax on the contribution and all the earnings at the point of withdrawal.

With a Roth, the employee avoids the tax on the earnings, which creates a larger tax savings overall, especially for those whose income will continue to be high into retirement. This provision has a delayed effective date, which gives employers and record keepers time to assess how to administer plans with pre- and post-tax dollars.

This feature comes with many restrictions, including limitations on distributions. Employers should ensure that nondiscrimination testing is properly done.

Observation: Employers will have time to evaluate whether the Roth feature makes sense for their organization. They should evaluate the demographics of the employee population and take into consideration the additional administrative procedures and costs.

Tax Incentives for Retirement Plans

Tax Credit for IRA Contributions

Another provision new to this legislation is nonrefundable tax credits equal to a percentage of the individual's contribution to an IRA or elective deferral for certain individuals.

The maximum credit is $1,000 and phases out to zero if adjusted gross income is over $50,000 for joint filers, $37,500 for head of household, and $25,000 for others. The credit does not affect tax deductibility of contributions.

This new feature is effective for years beginning after Dec. 31, 2001, and ending in years beginning after Dec. 31, 2006.

For lower-wage earners, this makes savings for retirement even more attractive. For instance, an eligible single employee could contribute $2,000 to a deductible IRA and receive a $1,000 tax credit. This example again demonstrates that one of the primary intents of the new tax law is to provide incentives to individuals, primarily through the employment environment, to save greater amounts for retirement.

Observation: Many employers who employ lower-paid workers have difficulty with attraction and retention. The new tax credit for elective deferrals and IRA contributions

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is a major benefit for lower-wage earners if they take advantage of the opportunity. Employers who proactively educate and assist employees with financial issues such as this may gain a competitive advantage in the marketplace.

Tax Credit for Start-Up Plans

Another new provision that demonstrates the desire of Congress to provide incentives for retirement savings is the tax credit for employers that establish a retirement plan. Employers with fewer than 100 employees may receive a tax credit of up to $500 per year for three years for some start-up costs. The employer cannot take both a deduction and the tax credit for start-up expenses.

This provision applies to SIMPLE IRAs and SEPs as well as 403(b) and qualified plans. The new tax law also provides small employers with relief from IRS user fees for determination letter filings for new plans.

New Promotion of ESOPs

ESOPs are big winners under the new tax law. Starting in 2002, employers will be able to contribute to an ESOP up to $40,000 per plan participant annually. The deduction limit for contributions to nonleveraged C corporation ESOPs and to S corporation ESOPs is increased to 25 percent of compensation paid to participants.

Employees' elective contributions to 401(k) plans are included as compensation but are not applied against the 25 percent deduction limit. The maximum benefit that may be allocated to employees' accounts each year is increased to $40,000 or 100 percent of compensation, whichever is less.

Thus, an employee earning $40,000 a year in 2002 will be able to receive annual contributions of $40,000, compared with $10,000 maximum under current limits. In addition, under the old law, ESOPs of C corporations could not deduct the amount of ESOP dividends paid if not paid in cash to the participant or beneficiary or used to pay off a loan associated with the ESOP.

The new law lets C corporations that allow participants and beneficiaries the option to reinvest ESOP dividends or to receive the dividends in cash to take a deduction on such dividends. This provision applies to plan years beginning after Dec. 31, 2001. These provisions create many new opportunities for ESOPs of both C and S corporations.

Although the new law is generally favorable toward ESOPs, it should be noted that, beginning in 2003, an ESOP in an S corporation that does not benefit a broad group of employees might be subject to significant penalties.

Observation: ESOPs may once again become a preferred tool to raise capital, offer tax benefits to the owners of closely held businesses, and provide motivation to employees.

The new dividend treatment under the new tax law is also an opportunity for 401(k) plans invested in company stock to take advantage of this same deduction by designating a portion of the plan that includes company stock to be an ESOP.

Employer-provided Retirement Advice

As long as qualified retirement planning services are offered on a nondiscriminatory basis, the cost of these services is excluded from income as a fringe benefit. This benefit is available for employees and their spouses for plan years beginning after Dec. 31, 2001.

Employers should ensure that a registered investment advisor (RIA) renders retirement advice so that the employer is not subject to a breach of fiduciary responsibility.

New Rules for Distributions, Loans, and Rollovers

Shorter Wait after Hardship Distributions

The IRS is directed to revise regulations so that when an employee takes a hardship withdrawal, he or she may begin making deferrals again after six months rather than the 12 months allowed under the current law.

This provision is effective for plan years beginning after Dec. 31, 2001, and eases the employee's penalty for taking a hardship withdrawal.

Rollover of Hardship Distributions Not Allowed

Formerly, rollovers were permitted for plans except for 401(k) plans. Under the new law, anything called a hardship distribution by the plan will generally be ineligible for rollover distribution, effective after Dec. 31,

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2001. This change expands the IRS position on hardship rollovers and reduces the burden on employers to treat different types of hardship withdrawals differently.

Plan Loans for Business Owners

Formerly, owners of Subchapter S corporations, partners in partnerships, and sole proprietors were not allowed to take plan loans.

Beginning in 2002, they will be permitted to take loans provided the plan has a loan provision, thus making qualified plans more attractive to business owners. This provision, along with the relaxing of top-heavy rules, creates more parity in plan participation between business owners and other employees.

Observation: The S election is a popular choice among closely held businesses because of the tax benefits for the owner. S corporations, however, do not enjoy the same tax benefits as C corporations as they pertain to employee benefit plans. The new tax law improves the tax treatment and flexibility for employee benefit plans of S corporations but falls short of parity for C corporations. This fact, along with future lower individual tax rates that apply to owners of S corporations because they are pass-through entities, may cause more corporations to switch to an S election.

New Portability for Plan Rollovers

A new provision in the new law will most likely create significant transfer activity in the not-for-profit sector—the ability to exchange 403(b), 401(k) and 457 dollars. Previously, rollovers to or from 457 plans to non-457 plans were not allowed. Rollovers from 403(b) plans were only allowed to another 403(b) plan or an IRA.

Employees who changed employment from an employer maintaining one type of plan to an employer maintaining a different type of plan were typically unable to consolidate their account balances with the new employer. Not only is the result confusing, but it may also be costly to pay fees and expenses on multiple plans.

Under the new law, rollovers to and from nonfederal governmental 457 plans to other plans or IRAs are permitted (although a 10 percent additional tax on early distributions now applies to such amounts rolled into 457 plans, consistent with other plans).

457 plans accepting rollovers must separately account for non-457 plan rollovers into these plans. Rollovers to and from 403(b) plans to other plans or IRAs are now permitted. Plans must allow direct rollovers into other plans.

These provisions take place for distributions after Dec. 31, 2001. These provisions greatly increase the portability of plan dollars among different types of plans. The IRS will be issuing a revised safe harbor notice regarding rollovers. Those eligible for 10-year averaging are subject to special rules.

Observation: Not-for-profit organizations were permitted to offer 401(k) plans as a result of the 1996 Small Business Job Protection Act. Because 403(b) plans could not be transferred to 401(k) plans, however, many organizations either kept their old 403(b) plan or maintained two or more plans. The new freedom to roll over money from a 403(b) plan to a 401(k) plan creates opportunities for not-for-profit organizations to combine multiple types of plans into one. Consolidated plans may create cost savings in administrative and investment management expense as well as greater clarity in communication and enrollment.

Automatic Rollovers to IRAs for Certain Distributions

Plans may "cash out" accounts that are immediately distributable that do not exceed $5,000 without the participant's consent by distributing amounts to the participant under current law.

With the new law, however, accounts that are immediately distributable that do not exceed $5,000 but are over $1,000 must roll the distribution directly to an IRA, unless the participant elects to receive the distribution directly or to roll it over to another account.

This provision is a takeoff of the increasingly popular "negative election" procedures that may now be used for certain benefit enrollments. Employees may not take the time to complete paperwork for enrollment or termination of benefits. Rather than an employee forfeiting benefits because of his or her inertia, "negative elections" create a default option in the plan of the employer's choice.

If the employee does not wish to participate in the

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plan or would like a different alternative than the default option, he or she must "positively elect" another option.

This provision is not effective until final regulations are issued by the Department of Labor (DOL) providing for fiduciary "safe harbors." This change affects both the tax code and ERISA provisions.

Congress recognized that there would be fiduciary issues involved when an employer selects investment accounts on behalf of participants and that the cost of an IRA may eat away a small account balance. Congress has asked the regulators to consider providing special relief regarding use of low-cost IRAs. The DOL has three years after the date of enactment to issue the safe harbor regulations.

The automatic rollover provision, along with many other features of the new tax law, are consistent with the primary intent of recently permissible negative elections, namely to encourage and help employees save for retirement. It is estimated that over 70 percent of employees who receive distributions from retirement plans take the money in cash, subject to tax and penalties, rather than rolling the account over to an IRA or another qualified plan.

Spousal Rollovers in Event of Employee's Death

Formerly, if an employee died and the surviving spouse received a distribution from a qualified retirement plan, rollovers were permitted only to an IRA. Under the new law, rollovers may be made to another qualified plan, a 403(b) plan, and a nonfederal 457(b) plan beginning in 2002.

Relaxed Rules for IRA Rollovers into Qualified Plans

Under current law, qualified money could be rolled into an IRA but only money that came from a qualified plan could be rolled from an IRA back to a plan. An IRA with only qualified plan money was referred to as a "conduit IRA."

Beginning in 2002, rollovers of IRAs to a qualified plan, 457(b) plan, or 403(b) plan will be allowed regardless of whether the IRA was a conduit IRA. Thus, there will no longer be "tainted" money inside of certain IRAs that block rollovers.

These new provisions will enable participants to consolidate retirement accounts into one or a smaller number of plans. However, it should be noted that employers are not required to establish plans that accept rollovers. In addition, plans that are eligible for 10-year averaging are subject to special rules.

Rollovers of After-Tax Contributions

Formerly, rollovers of after-tax contributions were not permitted. Under the new law, rollovers of after-tax contributions from a qualified plan are permitted either to a defined-contribution plan or to an IRA. This provision takes effect for plans beginning after Dec. 31, 2001.

Employers should keep in mind that for a plan to accept after-tax contributions, it must account for the after-tax amounts separately, which increases its administrative cost.

Exception to 60-Day Rollover Rule

Under current law, nondirect rollovers must be completed within 60 days of receipt of the initial distribution to be nontaxable. The IRS has rigidly applied the 60-day rule, but the new law permits the IRS to waive the 60-day rule in limited cases. Beginning in 2002, these cases may include casualty, disaster, or other events beyond the individual's reasonable control.

Modified Same-Desk Rule

A new phrase, "severance from employment," used for 401(k), 403(b), and 457 plans is intended to make it easier to get distributions when businesses change hands beginning after Dec. 31, 2001. 401(k) plan distributions are permitted only for a "separation of service" and 403(b) and 457 plans operate under a similar rule.

Under the "same-desk" rule, the IRS had found that an employee who does the same job for the new employer in the same location (for example, when the employer is acquired by a new entity) generally did not experience a "separation from service" and could not receive a distribution.

Although the intent seems to be to liberalize the

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rules, employers should proceed with caution until there is a track record for determining severance from employment in different situations.

Relaxed Rules for Cashing Out Terminated Employee Accounts

Under the new law, rollover contributions may be disregarded in determining whether an account is under $5,000, effective after Dec. 31, 2001. Now plans with less than $5,000 may be "cashed out" without regard to the portion of the account attributable to a rollover from another plan.

This rule makes the administration of distributions easier for employers but employers should take into consideration the other new provisions, as discussed above, regarding distributions.

Reduced Regulatory Burdens

Relaxed Top-Heavy Rules

Currently, top-heavy rules look back at a five-year history of contributions to the plan by key employees. Key employees are defined by complex definitions, which also look at a five-year history. Matching contributions generally are not included in determining a minimum contribution because of nondiscrimination rules.

Under the new law, only one year of contributions will generally be considered. The definition of a highly compensated employee is made somewhat less complex and also looks at a one-year history. Matching contributions may be used in minimum-contribution calculations without violating nondiscrimination rules.

These rules will simplify the data gathering needed to determine top-heaviness. The ability to use matching contributions without violating nondiscrimination rules will make matching plans more attractive to some employers.

Observation: Although the top-heavy rules have been relaxed somewhat and the contribution limits have been greatly expanded, it may still be difficult for certain highly compensated employees to contribute the maximum amount to qualified plans. Nonqualified deferred-compensation plans benefit significantly from the future lower tax rates and may be viable alternatives for executives where qualified plans do not correct reverse discrimination.

Eased Rules for 401(k) and 403(b) Plans

Under current law, it is unclear whether employees of certain tax-exempt entities who are covered under a 403(b) plan may be excluded under 401(k) coverage testing. Congress has directed the IRS to modify regulations to provide that these employees are excludable for 401(k) coverage testing in certain situations.

This mandate reaches back to years beginning after Dec. 31, 1996. The effect of the new mandate will help employers who offer both a 403(b) and 401(k) plan to pass coverage testing, thus simplifying administration.

Relaxed Anti-Cutback Rules

A plan that eliminated an optional form of benefit with respect to previously accrued benefits violated the anti-cutback rules. Cutback rules, especially for merger situations, have been relaxed under the new law. There has been a trend toward easing anti-cutback restrictions, which makes it easier for plans to change benefit forms without carrying a lot of old forms of benefits.

The IRS is instructed to issue appropriate regulations to deal with changes that would have only a de minimus effect, beginning in 2002.

Repealed Multiple-Use Test

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.

The multiple-use test has been removed for plan years effective after Dec. 31, 2001. The multiple-use test added to the complexity of the testing, and its removal will make testing and administration easier to perform.

Combined Multiemployer Plan Limits

Defined-benefit plan limitation, under current law, is the lesser of $90,000 (adjusted annually for inflation) or 100 percent of compensation, except for governmental plans which are subject only to the $90,000 adjusted limit.

Employers who have more than one defined-benefit

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plan must combine them in applying the limit. Multiemployer plans are now subject only to the new $160,000 adjusted limit (which replaces the old $90,000 limit).

Multiemployer plans no longer have to aggregate plans in applying the limit, beginning in 2002. This change may ease some testing situations for employers with both multiemployer and non-multiemployer plans.

Observation: Although Congress attempted to relax the regulatory burden on employers for certain benefit provisions, the new law may actually create additional administrative challenges for plan sponsors that incorporate new provisions into their plans or adopt or eliminate plans.

Enhanced Education Benefits

Education IRAs

Most of the changes in the law affecting employee benefits focus on retirement plans. However, programs designed to enhance and facilitate education also received emphasis.

Under the old law, education IRAs were not popular primarily because of the small amount ($500) that an individual could contribute and because they were only available to those whose earnings were below stated thresholds.

The new law quadruples the contribution limit to $2,000 and opens the benefit up to taxpayers with higher incomes. It also removes the marriage penalty that often limited the amount that married couples could contribute on a pretax basis to education IRAs.

Under current law, the ability to make a contribution phases out as the contributor's modified adjusted gross income (AGI) goes from $150,000 to $160,000 ($95,000 to $110,000 if single). No further contributions can be made after the child reaches the age of 18, and the funds can only be used for postsecondary education.

Beginning in 2002, the new law changes all of these limitations. The phase-out range for married individuals is increased to twice that of singles ($190,000 to $220,000).

Contributions to education IRAs can be made after the child reaches the age of 18 in cases where the child has special educational needs. Funds may be withdrawn from education IRAs to fund K-12 schooling as well as postsecondary education.

Of particular note to employers is that corporations and other entities (including not-for-profit businesses) can make contributions to education IRAs regardless of the income of the corporation or entity during the year of the contribution. In contrast, for individual taxpayers the contribution limit is subject to a modified AGI phase-out range.

Observation: Employers may wish to consider adding education IRAs to enhance their benefit plans in a way that appeals to employees with young children.

Qualified Tuition Plans

The new law also expands the scope of qualified tuition programs and greatly enhances the tax benefit of distributions from the programs. Qualified tuition plans are typically referred to as Section 529 plans and allow taxpayers to make contributions on behalf of a beneficiary to a state-sponsored investment program.

Like education IRAs, contributions to 529 plans are "Roth-like," meaning they are not deductible but the earnings of the account go untaxed until withdrawn for the beneficiary's qualified postsecondary education expenses at which time they are taxed to the beneficiary.

The new law makes two major changes to these plans. Beginning in 2002, the plans will no longer be restricted to the states. Private institutions (private colleges and universities) will also be empowered to establish these plans.

Perhaps more important, the distributions will be tax free when used for qualified postsecondary education expenses beginning in 2002 for state-sponsored plans and 2004 for privately sponsored plans.

Employer-provided Educational Assistance

Under current law, an employer may provide educational assistance to an employee up to $5,250 but only applicable to undergraduate programs. This feature was scheduled to expire, but the new law makes the exclusion permanent. It also extends the provision to graduate programs for expenses related to courses beginning after Dec. 31, 2001.

Deduction for Higher-Education Expenses

Employers may wish to establish payroll deduction plans that permit employees to fund the cost of higher

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education. The new tax law, effective Jan.1, 2001, will allow taxpayers with AGIs of $65,000 or less ($130,000 for couples filing joint returns) to claim up to $3,000 in deductions for qualified higher-education expenses.

In 2004, the allowable deduction increases to $4,000. In that same year, the new law permits taxpayers with higher incomes (less than $80,000 single and $160,000 married filing jointly) a reduced deduction of $2,000. The new law repeals this provision after 2005. Table 8 outlines the deduction of education expenses.

TABLE 8

Deduction of Education Expenses

Year	AGI Joint returns <$130K; single returns <$65K	AGI Joint returns $130K-$160K; single returns $65K-$80K
2002	$3,000	$0
2003	$3,000	$0
2004	$4,000	$2,000
2005	$4,000	$2,000
2006	$0	$0

Tax Credits for On-Site Child-Care Facilities

The new law provides a credit for employers for up to 25 percent of qualified expenditures for employee child care and 10 percent of qualified expenditures for child-care resources and referral services. The maximum credit that an employer can claim is $150,000 per year. This provision is effective in 2002.

Observation: Almost 70 percent of respondents to the 2001 Grant Thornton Business Owners Council Survey identified attracting and retaining talented employees as one of the most important challenges facing their companies. A total of 10 percent identified it as the single most important challenge. One of the obstacles in finding and keeping talent is the need for employees to balance work-life issues and to obtain quality child care close to home or their place of employment. The new tax law provides a significant incentive for employers to create and maintain on-site child-care facilities. Those employers who incur this expense may carve out a competitive niche in the employment marketplace.

Other Changes

The new tax law has many other aspects that affect employee benefit plans. These include

- special 415 defined-benefit limit for commercial pilots
- changes to 415 defined-benefit limits applicable to collectively bargained plans
- church plans—limits affected
- purchase of service credit in governmental defined-benefit plans
- increased ability for self-employed with religious exemptions to save for retirement
- special top-heavy rules for frozen plans
- special rules to allow retirement savings for domestic workers
- determination of U.S. source income for nonresident aliens
- updated life expectancy tables for minimum distributions
- qualified domestic relations order for 457(b) plans addressed
- minimum-distribution rules for 457 plans changed
- defined-benefit plan funding and plan valuation rules changed and limited excise tax relief granted
- added disclosure requirements before changes in benefit levels in defined-benefit or money purchase plans and new excise tax for failure to comply with requirements
- change in rules governing how much in elective deferrals can be invested in employer stock
- new restrictions and 50 percent excise tax on allocations to disqualified persons in S-corporation ESOP
- multiemployer plan deduction timing rules addressed
- adoption assistance credit expanded
- dependent-care tax credit expanded
- clarification of relationship of time of deduction and method of accounting rules for multiemployer plans issued

In addition, beginning in 2004, 160 percent of the

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current liability funding for defined-benefit pension plans is repealed. And starting in 2002, up to 100 percent of unfunded termination liability is deductible. Some restrictions apply, however, to highly compensated employees in small plans.

Under the new law, nondeductible contributions exceeding the current liability full-funding limit are not subject to the excise tax for nondeductible contributions.

The new law significantly reduces plan benefit accruals. The administrator of a defined-benefit plan must provide a written notice concerning a plan amendment that allows a substantial reduction in the rate of future benefit accruals. This includes any elimination or reduction of an early retirement benefit or retirement-type subsidy. These changes apply to plan amendments taking effect after the date of enactment.

Since 1994, Congress has passed several pieces of significant legislation affecting qualified retirement plans. As a result of this legislation, plans must be rewritten entirely or "restated," as the IRS refers to this process.

Many of the legislative changes are advantageous to employers maintaining a retirement plan. With the benefit of the changes, however, comes the burden of incorporating them into existing plans.

The "remedial amendment period" is the period the IRS has determined is sufficient to enable an employer to incorporate all legislative changes into the written plan document. The remedial amendment period for the current legislative changes generally ends on the last day of the plan year beginning in 2001.

The IRS has extended the deadline for calendar-year plans to Feb. 28, 2002, even though many benefit practitioners expected the IRS to extend the deadline for GUST restatements. Thus, time is of the essence to review, design, and restate qualified retirement plans.

Meeting the Challenge

Although the Federal Reserve continues to stimulate the economy with rate cuts, the overall economy continues to struggle. The recent terrorist attacks have resulted in additional economic pressures on employers. The sectors that have experienced the greatest impact have been technology companies, airlines, and insurers, and unemployment is on the rise.

Employers, however, continue to rank the issues of attracting and retaining talented employees as one of the most important issues they face. In light of the economic downturn, many employers are taking a serious look at the cost of compensation and benefit plans and are seeking ways to maximize the significant investment that these plans require.

The new tax law, GUST, and the struggling economy present not only numerous challenges for American business but also a tremendous opportunity to craft new or improved benefit plans that are adapted to these changes. ■

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(1) GUST: G→GATT (Uruguay Round Agreements Act), U→Uniformed Services Employment and Reemployment Rights Act of 1994, S→Small Business Job Protection Act of 1996, T→Taxpayer Relief Act of 1997

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