

PENSION REFORM BENEFITS

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) contains many provisions that will improve and simplify the rules relating to qualified retirement plans. Virtually every important dollar figure and percentage limit has been increased, and many other favorable changes have been made. The net result is that beginning in 2002, many employees who are covered by a company retirement plan will have better tools with which to build a secure retirement future. That includes CEOs of major corporations, middle managers, and regular employees including those in the lower-paid group. However, many of the increased limits will not apply automatically. Your plan must be amended to incorporate those new rules.

Here’s a roundup of how EGTRRA will help employees build a more financially secure retirement future.

HIGHLY PAID EMPLOYEES

There’s a dollar limit on how much of an employee’s compensation can be taken into account when figuring various limitations on employer-sponsored retirement plans, such as maximum annual contributions or pensions. In 2001, the limit was \$170,000 but this year it is \$200,000.

Example. A corporation’s profit sharing plan contributes 10 percent of each participating employee’s salary to his or her plan account. One of its employee earns \$250,000. In 2001, the corporation could contribute \$17,000 to his account (10 percent of \$170,000). In 2003, its contribution for the employee will be \$20,000 (10 percent of \$200,000).

Two important annual limits apply to defined contribution plans, such as profit sharing and stock-bonus arrangements. One restricts the total amount that can be contributed by the employer and employee to each plan participant’s account, and the other restricts the amount of the contribution that can be deducted.

- In 2001, the maximum amount that could be contributed to each participant’s account is 25 percent of compensation or, if less, \$35,000. The maximum deductible contribution is 15 percent of the compensation paid to all employees covered by the plan.
- In 2003, the maximum that can be contributed to each participant’s account is 100 percent of compensation capped at \$40,000. The maximum deductible contribution will be 25 percent of the compensation paid to all employees covered by the plan.

Example. An architect has an incorporated practice that maintains a profit sharing plan. He is the only employee and his annual compensation is \$160,000. In 2001, the practice may contribute \$40,000 to the architect's account, but it may deduct only \$24,000 of the contribution (15 percent of \$160,000). In 2003, it can deduct \$40,000 (25 percent of \$160,000).

Using these increased limits with new IRS regulations for "New Comparability" plans will allow highly paid employees to receive disproportionately higher plan contributions. As a result, the cost of funding for other employees in order to achieve a maximum contribution for highly paid employees has never been cheaper.

Companies that maintain regular pension plans (those that pay a fixed annual or monthly amount when the employee retires) will be able to make larger pension payments. The maximum pension that a plan can fund is 100 percent of a participating employee's average compensation for his three highest paid years, limited by a dollar cap. Last year that dollar cap was \$140,000, but now it is \$160,000. In addition, no reduction in benefits will be required for plans with a normal retirement age of 62-64. This means a larger amount can be contributed on behalf of an employee (even more than \$40,000 depending on the employee's age).

Sole proprietors, 10 percent partners and 5 percent S Corporation shareholders will now be able to borrow from their retirement plan. Under the old law these owners were prohibited from borrowing funds from their plan. This provision also applies prospectively to preexisting loans.

REGULAR WAGE EARNERS

The change for 401(k) plans (also known as cash or deferred arrangements) are the most important ones for regular wage earners. There are five major changes you should be aware of:

- (1) There's a limit on how many pre-tax wage dollars you can defer each year. Last year, the maximum was \$10,500, but it now is \$13,000 in 2003. It will rise in \$1,000 annual increments, until it reaches \$15,000 in 2006. (These maximums also apply to 403(b) annuities, 457 plans and salary reduction SEPs (Simplified Employee Pensions)).
- (2) A new concept called "catch-up" contributions will allow employees who are 50 or older to make additional annual deferrals of pre-tax dollars. The maximum catch-up contribution for 401(k) plans (as well as for 403(b) annuities, and salary reduction SEPs) will be \$2,000 for 2003, \$3,000 for 2004, \$4,000 for 2005, and \$5,000 for 2006 and later years. As a bonus, the catch-up contribution will not be subject to the various limitations and requirements that normally apply to elective deferrals.

Example. A company's 401(k) plan allows employees to make elective deferrals up to 10 percent of compensation or the annual dollar limit, whichever is less. One of its employees, age 51, make \$70,000 a year. Now, she can make a regular elective deferral of \$7,000, plus an additional elective deferral of \$2,000. For 2006, she can make an additional elective deferral of \$5,000.

- (3) Beginning in 2002, any employee's elective deferral to a 401(k) plan will no be subject to the deduction limits for stock bonus and profit sharing plans. (In 2001, they were subject to the generally applicable deduction limits.) This makes it feasible for companies to allow employees to make larger elective deferrals (or to increase the company contribution).
- (4) Beginning in 2002, elective deferrals (as well as an employee's elective set-asides in a cafeteria plan) will be treated as "compensation" for purposes of applying the deduction limits that apply to profit sharing and stock bonus plans (as well as some other types of plans, such as employee stock ownership plans (ESOPs). In 2001, these deferrals were not treated as "compensation."

Example. A company maintains a profit sharing plan. It also has a 401(k) plan that allows employees to make elective deferrals up to 6 percent of salary. One of its employees earns \$50,000 and makes a maximum 401(k) elective deferral of \$3,000. (We'll assume all the other employees also make the maximum deferral). In 2003, the company can deduct up to \$12,500 for (1) contributions to the employee's profit sharing account, plus (2) matching contributions to her 401(k) account (\$12,500 is 25 percent of \$50,000). In 2001, the company could deduct no more than \$7,050 in profit sharing and matching 401(k) contributions (\$7,050 is 15 percent of [\$50,000 minus \$3,000 elective contribution]).

- (5) Any matching contributions that your company makes to your 401(k) account will have to vest at a faster pace. Under the old law, you must be 100 percent vested in matching contributions after (1) five years of service, or (2) after seven years, if you're 20 percent vested after three years, plus an additional 20 percent for each subsequent year. Beginning in 2002, you must be 100 percent vested in matching contributions after (1) three years of service, or (2) after six years (20 percent vested after two years, plus an additional 20 percent for each subsequent year). These are the same schedules that currently apply if your plan is top heavy.

Faster vesting aids employees who move from job to job. Keep in mind that your employer may have a more rapid vesting schedule for matching contributions, but it can't use a slower one than the tax law requires.

LOWER-INCOME EMPLOYEES

For 2002 through 2006, lower-income wage earners will get an unprecedented incentive to save for retirement. It will come in the form of a nonrefundable credit of up to 50 percent of elective contributions to employer plans or IRAs, in addition to any deduction or exclusion that would apply. The maximum annual contribution eligible for the credit is \$2,000. The credit rate (50 percent, 20 percent or 10 percent) depends on the taxpayer's filing status and adjusted gross income (AGI). For example, a joint filer with up to \$30,000 AGI gets 50 percent credit. The credit drops to 20 percent if AGI is \$30,000 to \$32,500, and to 10 percent of AGI is \$32,500 to \$50,000. There is no credit for joint filers if AGI is above \$50,000.

Only an individual who is 18 or over (other than a full-time student, or someone allowed as a dependent on another taxpayer's return for the year) will be eligible for the credit. Special anti-abuse provisions will apply.

OTHER CHANGES

Other changes if EGTRRA will make plans easier to administer and make employees' benefits more portable. In brief, EGTRRA:

- Permits rollovers from 401(k) and other qualified plans to tax deferred annuity (401) and other qualified plans to tax deferred annuity (403(b)) plans and government and non-profit deferred compensation (457) plans and vice versa.
- Loosens top heavy rules, including the following:
 - Employer matching contribution may be counted toward the top heavy minimum contribution.
 - Safe harbor plans (i.e., those providing only for a safe harbor match or non-elective contribution) are deemed to satisfy the top heavy rules.
- Reduces the 401(k) safe harbor hardship deferral suspension from 12 months to six months.
- Eliminates the IRS user fee for reviewing the plan document during the first 5 years of a small employer's plan (100 or less employees).

