2002 Summer Seminar

Changes in Tax Law

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Materials prepared by:
Kenton B. Vriezelaar
Vriezelaar Tigges Edgington
421 Nebraska Street, PO Box 1557
Sioux City, IA 51102-1557
712-252-3226
Fax: 712-252-4873

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CHANGES IN TAX LAW

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Kent Vriezelaar
Vriezelaar, Tigges, Edgington, Rossi, Bottaro & Boden, LLP
421 Nebraska Street, P.O. Box 1557, Sioux City, Iowa 51102
Phone: (712) 252-3226 Fax: (712) 252-4873
E-mail: kentv@pionet.net or kvriezelaar@siouxcitylawyers.net

I. Historical Perspective: HR 1836, the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") was signed by the President on June 7, 2001 (the "Enactment Date").

While EGGTRA was billed as a big tax cut, and there are significant cuts in the bill, a lot of it is smoke and mirrors. As Bush's reward to the electoral plurality that voted him into office, EGGTRA has something for everybody: targeted tax cuts and across-the-board rate reductions. However, many changes are deferred and/or phased in over ten years. The tax commentators are betting that many of the changes will be cut back or eliminated before full implementation occurs.

There is definitely a flavor of favoritism toward the the high income taxpayers, such as the promised repeal of the estate tax, and the phaseout of the personal exemption phaseout and the itemized deduction limitation. What EGGTRA didn't do was simplify the code or make tax planning any easier, either on the income tax side or the estate/gift side.

Congress giveth and Congress taketh away: If you think back, you can see there has been a pattern of large tax cuts periodically, with gradual increases in between. Then there are the periodic "reform" acts, like the 1986 Act, which was a major rewrite of the Internal Revenue Code (the "Code"). While the '86 act reduced individual statutory rates to fifteen percent and twenty-eight percent, it broadened the tax base by eliminating or limiting many exemptions and deductions. These included the "stealth" tax increases like the phaseout of personal exemptions and itemized deductions as taxable income increased.

After the big tax cuts, as deficits increase because of the tax breaks, Congress raises the rates to make up the shortfall: to thirty-one percent in 1990 and again in 1993 to thirty-six percent and 39.6 percent. We can expect to see that pattern repeated as the tax reductions in EGGTRA are whittled away through the next few years. And don't forget the sunset clause: in 2011 almost all of EGGTRA's changes are scheduled to go away and we'll be back to the pre-EGGTRA law again.

Summary of EGTRRA

The Act is divided into eight sections:

1. rate reductions ($875 billion);
2. tax benefits relating to children ($179 billion);
3. marriage penalty relief ($63 billion);
4. education incentives ($29 billion);
5. estate and gift tax phase relief ($138 billion);
6. retirement plan changes ($50 billion);
7. Alternative Minimum Tax relief ($14 billion);
8. sunset (right back where we started).

The first seven are where Congress giveth, the eighth is where Congress taketh it all away.

1. Marginal Rate Reductions

   a. Effective January 1, 2002, a new ten percent bracket for the first $6,000 of income for single individuals/$12,000 for married filing jointly. These ceilings will increase to $7,000 and $14,000 in 2008, and indexed for inflation after that. The $300/600 checks we got were really a way to avoid redoing the rate tables for 2001 and represent what the rate reduction would have done if implemented for the last half of 2001.

   b. The other income tax rates will gradually drop over the next six years and be fully effective in 2006. The twenty-eight percent bracket will drop to twenty-five percent. The thirty-one percent bracket will drop to twenty-eight, the thirty-six percent bracket to thirty-three, and the 39.6 percent bracket to thirty-five.

   c. The limitation on itemized deductions and personal exemptions will be phased out over four years, beginning in 2006 until they are finally eliminated in 2010. This will have the effect of reducing marginal rates for taxpayers subject to those provisions.

2. Tax Benefits Relating to Children

   a. Over the next ten years, the child tax credit will increase from $500 to $1,000 per child and become fully refundable to the extent of ten percent of the taxpayers' income in excess of $10,000 through 2004 (fifteen percent beginning in 2005), kicking in at the the earned income tax credit cap.

   b. The adoption credit is made permanent, increased to $10,000 per child, and the phaseout range is increased. Beginning in 2003, the credit is appliea in the year

that a specialized-needs adoption is finalized, regardless of whether the taxpayer has adoption expenses.

c. The amount of expenses that qualify for the dependent care tax credit is increased to $3,000 for one child, $6,000 for two. The maximum credit was increased and the phaseout begins at a higher income level.

d. There is also a tax credit for employer-provided child care facilities.

3. Marriage Penalty Relief

a. Under pre-EGGTRA law, the standard deduction for a married couple is 167 percent of the standard deduction for single individuals. By 2009 the standard deduction for a married couple will increase to twice that of a single individual.

b. Under pre-EGGTRA law, the top of the fifteen percent rate bracket for a married couple is 167 percent of that for single individuals. By 2009 it will be twice that of a single filer.

4. Education Incentives

a. The size of the contribution that can be made to an education IRA was increased from $500 to $2,000, along with an expansion of the definition of qualified expenses, and an increase in the phaseout range.

b. The exclusion for employer-provided educational assistance was extended to graduate education, and the exclusion for both undergraduate and graduate education made permanent.

c. The Act increased the income phaseout range for eligibility for student loan interest deductions and eliminated the sixty-month limitation on the deductibility of student loan interest.

d. The Act provides a new deduction for higher education expenses. It is an above-the-line deduction for qualified higher education expenses. The maximum deduction is $3,000 in the first two years, and increases to $4,000 in 2004 and 2005. This provision is only around until 2005, and then it sunsets.

e. Other education provisions affect prepaid tuition programs, sponsored educational facilities and activities, and favorable tax treatment for certain awards and scholarships.

5. Estate, Gift, and Generation-Skipping Transfer Tax (see detailed outline attached)

a. increases in the exemption

b. decreases in the rates

c. All transfer taxes will be gone in 2010. (only to return in 2011!)

d. except the gift tax will continue at a maximum rate of 35%.

e. Should you advise your clients that the best tax planning is to die in 2010?

6. Pension and IRA Changes (see detailed outline attached)

   a. Increases in the amount of IRA contributions,

   b. improved portability,

   c. simplification of the employer-sponsored plan rules,

   d. incentives for people to participate in plans, including credits for people low income taxpayers who contribute to an IRA,

   e. catch-up provisions,

   f. faster vesting rules.

7. Alternative Minimum Tax Relief

   a. The individual alternative minimum tax exemption amount was increased by $2,000 for single taxpayers and $4,000 for married taxpayers.

   b. The EITC and child credit are no longer limited by the AMT.

8. Sunset. Because of the Congressional Budget Act, the Act provides that all of its provisions generally case to apply for taxable years beginning after December 31, 2010. I think we'll see so many changes to the Code before then that they won't be able to figure out which sections the sunset applies to by then.

II. Estate and Gift tax Changes: Detail

Historical Perspective: The 1976 Tax Reform Act created the unified transfer tax system which required that lifetime gifts, in excess of the annual exclusion, made after 1976 increased the rate of estate tax applicable at death. EGTRRA reverses most of this unification. EGTRRA phases out the estate tax over nine years and repeals it and generation skipping transfer ("GST") in 2010. It makes many other changes to the estate, gift and GST taxes, but does not repeal the gift tax.

EGTRRA's sunset provision repeals those changes on January 1, 2011 and reinstitutes Pre-EGGTRA law. The phased changes, repeal and scheduled re-institution of Pre-EGGTRA law make planning in the area much more difficult.

A. Repeal of the Estate Tax.

EGTRRA gradually increases the lifetime exclusion amount and decreases the top estate tax rates as follows:

Year	Exclusion Amount ($)	Top Marginal Rate (%)
2001	675,000	55 (60 over $10,000,000)
2002	1,000,000	50
2003	1,000,000	49
2004	1,500,000	48
2005	1,500,000	47
2006	2,000,000	46
2007	2,000,000	45
2008	2,000,000	45
2009	3,500,000	45
2010	Unlimited	N/A
2011 fwd	1,000,000	55 (60 over $10,000,000)

1. Note that in 2006, when the lifetime exclusion reaches $2,000,000, it will exceed all the lower brackets, making the top marginal rate estate tax (46% in 2006, 45% after) the only rate. Thus the estate tax will be a flat tax until repealed/reinstated IRC Sec. 2001(c).

2. Both the estate tax and the GST are scheduled for repeal in calendar 2010 and reinstatement January 1, 2011. EGTRRA Sec. 501(a); IRC Sec. 2210(a); IRC Sec. 2664. The sunset provision reintates the lifetime exclusion at $1,000,000 in 2011, rather than the $675,000 in effect pre-EGGTRA because the lifetime exclusion was scheduled to reach $1,000,000 by 2006 under pre-EGGTRA law.

3. Special rules:

   a. if a disqualifying event occurs after repeal, tax benefits will be recaptured for pre-EGGTRA special use valuation (IRC Sec. 2032A), qualified family owned business deduction (IRC Sec. 2057) or deferral of federal estate taxes attributable to a business interest (IRC Sec. 6166).

   b. The estate tax remains in effect after repeal with respect to a qualified domestic trust (QDOT) for a non-U.S. citizen surviving spouse, if the decedent who created the QDOT dies before 2010.

B. Gift Tax Continues: The gift tax will not be repealed, but the gift tax lifetime exclusion increased to $1,000,000 in 2002 and will stay there indefinitely, (no COLA provision).

1. In 2004, the estate tax lifetime exclusion will increase to $1,500,000, but the gift tax lifetime exclusion will remain at $1,000,000, thereby creating a tax incentive to hold property until death.

2. In 2010, the gift tax will become a flat tax too: 35% on gifts over $1,000,000.

C. Generation Skipping Transfers:

1. Starting in 2004, the GST exemption will be equal to the estate tax exemption and will apply to both inter vivos and testamentary transfers. The GST tax rate will be the top estate tax rate.

2. If GST events occur after repeal, there will be no GST tax incurred, even for trusts established before repeal, i.e., no special recapture rule for GST. IRC Sec. 2264.

D. State Death Tax Credit:

1. The state death tax credit will be reduced from the 2001 level by 25% in 2002, 50% in 2003 and 75% in 2004, and gone completely after 2004.

2. Starting in 2005 it will be replaced with an unlimited state death tax deduction. EGTRRA Sec. 531, IRC Sec. 2011(g).

E. Carry-Over Basis: Beneficiaries inheriting property from a decedent who dies after 2009 may have a new tax basis, but it won't be the simple stepup (or down) to FMV at date of death. Sec. 541, IRC Sec. 1014(f), Sec. 1022.

1. The starting point is a new adjusted basis equal to the **lesser** of the (i) the decedent's adjusted basis or (ii) the fair market value ("FMV") of the property at date of death ("DOD"). This is one of those stealth tax increases: we lose stepped-up basis but keep basis step-down.

a. The decedent's personal representative may then allocate as additional basis among the decedent's specific assets an amount equal to the sum of (i) $1,300,000 plus the decedent's (ii) unused capital losses, (iii) net operating losses and (iv) certain built-in losses, but cannot increase the basis of an asset to more than FMV at DOD. IRC Sec. 1022 (b)(2)(B), IRC Sec. 1022(d)(1).

b. Another $3,000,000 of additional basis can be allocated to property transferred to a surviving spouse if such property would have qualified for the estate tax marital deduction. IRC Sec. 1022(c).

c. Both the $1,300,000 and $3,000,000 amounts are indexed for inflation.

d. The additional basis adjustments can be made only to property owned by the decedent at death, including property held in a revocable trust, except:

(i) the allocation is only applicable to that portion of the joint property included in the decedent's gross estate under IRC Sec. 2040.

(ii) no allocation can be made made to property over which the decedent held a general power of appointment. IRC Sec. 1022(d)(1).

e. The additional basis adjustment for property going to non-resident aliens is only $60,000, indexed for inflation. IRC Sec. 1022(b)(3).

2. There is no basis adjustment for the following assets:

a. IRD items (see IRC Sec. 691);

b. property acquired from non-spouses within three years of the decedent's death;

c. certain foreign investments.

3. Reporting requirements:

a. The donor must report to the donee, and the donee to the IRS, basis information for non-cash gifts.

b. If the estate has more than $1,300,000 in non-cash assets or if the decedent gave away appreciated property received by the decedent within three years of death, the personal representative must report basis information to the IRS and the recipients.

c. Penalties for failure to report:

(i) $10,000 for the failure to report to the IRS transfers of non-cash assets in excess of $1.3 million or certain appreciated assets acquired from a decedent who acquired such assets within three years of death.

(ii) $500 for failure to report to the IRS transfers of appreciated property that were transferred to the decedent within three years of death.

(iii) $50 for failure to report to the property recipient.

(iv) For intentional failures, the penalty is 5% of the FMV of the property for which reporting was required.

(v) The penalty can be waived for reasonable cause. IRC Sec. 6018, 6019 and 6716.

4. Miscellaneous:

a. Gain or loss on the transfer of property in satisfaction of a pecuniary bequest after 2009 will be recognized only to the extent (i) FMV at the time of the transfer exceeds (ii) FMV on DOD, rather than carryover basis. IRC Sec. 1040.

b. The $250,000 exclusion on sale of a principal residence will be available to estates and heirs if the decedent used the property as his or her principal residence two or more of the five years before the sale. If the heir sells the residence, the heir can tack the decedent's occupancy time to the heirs own occupancy inorder to meet the rule. IRC Sec. 121(d).

F. Miscellaneous.

1. QFOBI (IRC Sec. 2057) is repealed for decedents dying after December 31, 2003. EGTRRA Sec. 521(d), IRC Sec. 20576).

2. IRC Sec. 6166 is loosened for decedents dying after December 31, 2001.

3. IRC Sec. 2032A has a technical issue resolved.

III. Pension and IRA Changes Detailed Outline

A. The stated purpose of the Act's retirement plan provisions is promote saving for retirement and simplify administration of retirement plans.

The Act:

1. Increases the annual limits for contributions to individual retirement accounts ("IRAs");

2. Increases the limits for employer and employee elective contributions to qualified retirement plans ("QRPs");

3. Allows additional contributions for older workers;

4. Allows more and easier rollovers of retirement plan benefits, including transfers in mergers and acquisitions;

5. Simplifies administration of some QRPs.

The Act has no deadline for amending plans for the changes made by the Act nor does it extend the 12/31/2001 deadline for the GUST amendments required by four recent tax acts. Nevertheless, retirement plans will need to be brought into compliance with the changes required by the Act. Employers will also have to decide which of the Act's optional changes to implement for their QRPs and should also consider the Act's impact on their non-qualified deferred comp plans since many of their benefits may now be provided by QRPs.

Many of the voluntary changes will add significant cost to providing benefits because of the increased limits, but many employers will choose to add them to help retain and recruit employees.

The effective date for the following provisions is for years beginning on or after January 1, 2002, unless otherwise noted. All provisions of the Act are scheduled to sunset for years beginning on or after January 1, 2011, when QRPs and IRAs will revert to pre-Act law.

B. INCREASED CONTRIBUTION AND BENEFIT LIMITS:

Pre-EGGTRA, Code Sec. 415 imposes annual contribution and benefit limits for QRPs as follows:

For a defined benefit (DB) plan, the maximum annual benefit payable to a participant at retirement is limited to the lesser of:

(i) 100% of the participant's highest three years of average compensation, or

(ii) $140,000

The limit is reduced if benefits begin before, and increased if they begin after, the Social Security retirement age.

For defined contribution (DC) plans, the maximum annual contribution for a participant is the lesser of:

(i) 25% of compensation or

(ii) $35,000

Both dollar limits are indexed for cost-of-living adjustments (COLA) in $5,000 increments.

Note that these limits are imposed on each participant, not the plan as a whole. Contrast the Code Sec. 404 15% deduction limit imposed on the plan as a whole, infra.

The Act increases the annual limits:

To $160,000 for DB plans, reduced for benefits beginning before age 62 and increased for benefits beginning after age 65.

For DC plans, to the lesser of:

(i) 100% of compensation or

(ii) $40,000, with COLA adjustments in $1,000 increments.

The increased limits will allow some employers to reduce or eliminate non-qualified deferred comp plans because they can provide the increased benefit formerly supplied by such non-qualified deferred comp plans on a tax deductible basis.

See Rev. Rul. 2001-51, 2001-45 IRB __.

C. COMPENSATION LIMITS: The limit on the amount of a participant's compensation that can be counted for plan purposes affects both the employer's deduction limit and the annual contributions to a participant's account.

The pre-EGGTRA limit is $170,000, indexed for COLA in $10,000 increments.

The Act increases the limit to $200,000, with $5,000 COLA increments.

The change allows employees to save more for retirement and the employer to receive a greater tax deduction.

D. ELECTIVE DEFERRAL LIMITS: Employees can elect to contribute on a pre-tax basis to 401(k) plans, 403(b) plans (tax deferred annuities/tax-exempt employer) or simplified employee pension plans (SEPs).

The pre-EGGTRA elective deferral limit is $10,500 with $500 COLA increments.

The Act increases the limit to $11,000 for 2002, and $1,000 more each year until it reaches $15,000 in 2006. After that the old COLA applies.

The Act increases the maximum elective deferral limit for SIMPLE plans and 457 plans (deferred compensation plans of state or local governments or tax-exempt organizations). It repeals the rules tying the dollar limit under 457 plans to those under 401(k) and 403(b) plans.

E. PLAN LOANS FOR S CORPORATION SHAREHOLDERS, PARTNERS AND SOLE PROPRIETORS

Pre-EGGTRA law allows plan loans to participants in a QRP sponsored by a C corporation, provided certain conditions are satisfied, even if the participant is the sole shareholder of the C corp, but does not allow plan loans to a sole proprietor, a partner owning more than 10% of a partnership, or an employee or officer of an S corporation owning more than 2% of the S corporation's stock. (Sec. 1372 treats 2%+ S corp shareholders as self-employed for fringe benefit purposes.) This is one of several instances where the Code (the Internal Revenue Code of 1986, as amended) discriminates against the self-employed.

The Act eliminates the restriction on plan loans for all owner-employees, including S corporation shareholders.

The Act does not allow loans to IRA owners.

F. TOP-HEAVY RULES EASED: Pre-EGGTRA law provides that a QRP is top-heavy if more than 60% of the total accrued benefits for a DB plan, or total account balances for a DC plan, are for key employees.

This determination is usually made as of the last day of the preceding plan year and includes distributions made on behalf of a participant within the five-year period ending on such date.

A "key employee" is an employee who, during the plan year that ends on such determination date or any of the four preceding plan years, is

(i) an officer earning over one-half of the DB plan dollar limit,
(ii) a five percent owner,
(iii) a one percent owner earning over $150,000, or
(iv) one of the 10 employees earning more than the DC plan dollar limit with the largest ownership interest.

In determining whether an employee meets the criteria in (ii), (iii) or (iv), constructive ownership rules apply.

If a plan is top-heavy for a given year, minimum contributions must be provided for, and minimum vesting schedules must be applied to the accounts of, non-key employees for such year. Employer matching contributions may be used to satisfy the minimum contribution requirement, but then they will not be treated as matching contributions for purposes of applying the nondiscrimination rules to matching contributions.

The Act:

provides that in determining whether a plan is top-heavy, only distributions due to termination of service during the year in which the determination is being made are taken into account. The pre-EGGTRA five-year rule would, however, continue to apply with respect to in-service distributions.

modifies item (i) of the definition of key employee to an officer with compensation in excess of $130,000 with $5,000 COLA increments, and

eliminates item (iv) above from the "key employee" definition.

provides that in determining whether an employee is a key employee, the employee is considered a key employee if he or she is a key employee during the preceding plan year and repeals the four-year look-back rule for such determination.

provides that matching contributions used to satisfy the minimum contribution requirement for a top-heavy plan may also be treated as matching contributions for purposes of the nondiscrimination rules.

G. EXPANSION OF DEDUCTION LIMITS ON EMPLOYER CONTRIBUTIONS:

Pre-EGGTRA, Code Sec. 404(a)(3) limits the annual deduction of an employer sponsoring a profit sharing plan (including a 401(k) plan) to 15% of the total covered compensation of employees who are eligible to participate in the plan during the year. This limit applies to the plan as a whole; individual employees may contribute more than 15% as long as the average contribution is 15% or less.

Employees' pre-tax elective deferral contributions to a 401(k) plan are "employer contributions" and count towards the 15% limit, but such elective deferrals are not counted as part of covered compensation for the deduction limit. These are both bad things.

The employer's deduction limit for a DB plan or a money purchase pension (MP) plan generally equals the plan's minimum funding requirement. Employers offering both types of plans generally are subject to an annual total deduction limit of 25% of compensation or, if more, the amount needed to meet a DB plan's minimum funding requirement for that year.

The Act:

increases the 404(a) profit sharing deduction limit from 15% to 25% of total covered compensation of plan participants.

includes elective deferral contributions of plan participants in total covered compensation of plan participants.

excludes elective deferral contributions from "employer contributions". They are therefore not subject to the deduction limits.

These are all good things.

Because of the interplay of the 415(c) 25% participant contribution limit with the 404(a) 15% deduction limit under the old law, many employers had both a money purchase (MP) pension plan and a profit sharing (PS) plan. They'd put 10% in the MP plan and 15% in the PS plan to get the maximum 25% into their retirement plans each year.

This meant maintaining two separate plans for the same employees. The increase in the 404(a) profit sharing deduction limit to 25% of compensation will allow these employers to have only one plan and reduce administrative expenses. The less flexible money purchase plan will likely be jettisoned.

The elimination of elective deferrals from both employer contributions and compensation for purposes of the 404(a) limit will encourage employers to modify their 401k plans to expand the amount of elective deferrals each employee can make to the plan.

H. ROTH CONTRIBUTION ACCOUNTS IN QRPs: Beginning in 2006, the Act permits a 401(k) or 403(b) plan to allow participants to decide whether to have elective deferrals treated as "Roth contributions."

Under the Act, Roth contributions would not be excludable from gross income when contributed, but such contributed amounts and all earnings thereon would be excludable from gross income when distributed.

Roth contributions would be treated the same as other elective deferrals for purposes of the rules relating to limits, nonforfeitability and distributions.

If an employer permits Roth contributions, it would be required to establish a separate accounts and records for such contributions, thus adding to the cost of administration.

I. TAX CREDIT FOR ELECTIVE DEFERRALS AND IRA CONTRIBUTIONS: The Act provides a non-refundable tax credit to the employee/taxpayer for IRA contributions and elective contributions to 401(k) plans, 403(b) plans, Sec. 457 plans, SIMPLE plans, SEPs, including voluntary after tax contributions.

The credit is available to individuals 18 to 59 years old but only for years 2002 through 2006.

The maximum annual contribution eligible for the credit is $2,000. Eligible contributions are reduced by retirement distributions in the same year.

The amount of the credit is 50% of the contribution (subject to the $2,000 limit) for joint filers with less than $30,000 adjusted gross income ("AGI"). The credit percentage starts to phase down after that until it's phased out at $50,000 AGI. The AGI amounts for single taxpayers are half that of joint filers (75% for head of household).

See Announcement 2001-106 for Q & A's on the credit.

J. NEW PLAN TAX CREDIT/EXEMPTION FROM USER FEES

The Act provides employers with 100 or less employees who adopt a new plan with an income tax credit equal to 50% of the first $1,000 of administrative and retirement-education expenses incurred for each of the first three years after the adoption of the new plan. The plan must have at least one non-highly compensated employee participating.

The Act also exempts such small employers from paying the user fee for application to the IRS for a determination letter for the new plan. Such fees range from $250 to $1,250.

K. OLDER WORKERS ELECTIVE DEFERRAL CATCH-UP CONTRIBUTIONS: Pre-EGGTRA, the maximum amount of elective deferrals that an individual may make to a 401(k) or 403(b) plan or SEP is $10,500.

The Act allows individuals who have reached age 50 by the end of the plan year to make catch-up contributions over and above the usual elective deferral limits but not more than the participant's compensation for the year, reduced by any other elective deferrals.

The catch-up amount is $1,000 for 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005 and $5,000 in 2006 and thereafter, with $500 COLA increments.

The catch-up deferrals are not subject to any other contribution limits or non-discrimination testing requirements but employer matching contributions for them are.

SIMPLE plans and 457 plans have lower limits. For SIMPLE plans, the catch-up amounts are 50% less.

L. FASTER VESTING OF EMPLOYER MATCHING CONTRIBUTIONS: Pre-EGGTRA, employer matching contributions are subject to either five-year cliff or seven year graded vesting schedules.

For years beginning in 2002, the Act requires employer matching contributions to be subject to three-year cliff or six-year graded vesting schedules.

Under three-year cliff a participant is 0% vested before completing three years of service and 100% vested after that.

Under six-year graded vesting, a participant is 20% vested after 2 years, 40% after 3, 60% after 4, 80% after 5 and 100% vested after six years of service.

The effective date is delayed until 2006 for plans provided under a collective bargaining agreement (CBA).

M. DIVISION OF 457 PLAN BENEFITS UPON DIVORCE: ERISA generally forbids assignment of a participant's QRP benefits to creditors.

An exception is made for division of benefits in a divorce under a qualified domestic relations order ("QDRO"). Amounts distributed to a spouse or former spouse (an "alternate payee") of a participant under a QDRO are taxable to the alternate payee. Pre-EGGTRA, the QDRO rules do not apply to 457 plans.

The Act expands the QDRO rules to include all employer-sponsored retirement plans,

including 457 plans. 457 plans will be subject to the government and church plan QDRO rules which omit certain procedural requirements applicable to QRP QDROs.

N. HARDSHIP WITHDRAWALS: Generally, 401(k) elective deferrals may not be distributed until retirement, death or disability.

An exception is made for distributions necessary to meet a financial hardship of the employee, defined as an immediate and heavy financial need, such as medical and educational expenses, and expenses related to purchasing a primary residence.

An employee may not make employee and elective contributions to any plans maintained by the employer for at least 12 months after receipt of the hardship withdrawal.

The Act shortens the 12-month period to six months.

Pre-EGGTRA, hardship withdrawals of elective deferrals under a 401(k) plan or 403(b) plan may not be rolled over to an IRA. The Act provides that all hardship distributions from a QRP, whether or not from elective deferrals, are ineligible for rollover.

O. PENSION COVERAGE FOR HOUSEHOLD WORKERS: Pre-EGGTRA, employers running a trade or business may make deductible contributions to QRPs for employees. Subject to certain exceptions, a 10% excise tax applies to nondeductible contributions to such plans.

Employers of household workers may establish a pension plan for such employees. Contributions to such plans are not deductible by the employer because not made in connection with a trade or business. Therefore they are subject to the excise tax on non-deductible contributions.

The Act eliminates the 10% excise tax on contributions to a SIMPLE plan or a SIMPLE IRA which are not deductible solely because not made in connection with a trade or business.

P. EASING PORTABILITY

1. Expanded Rollover Options:

a. Pre-EGGTRA law:

(i) an "eligible rollover distribution" from a QRP may be rolled over tax-free to a traditional IRA or another QRP,

(ii) eligible rollover distributions from a 403(b) plan may be rolled over into a traditional IRA or another 403(b) plan,

(iii) distributions from a traditional IRA can be rolled over into another traditional IRA,

(iv) distributions from a 457 plan can only be rolled over to another 457 plan,

(v) after-tax employee contributions and required minimum distributions cannot be rolled over, and

(vi) a surviving spouse who receives an eligible rollover distribution may only roll over the distribution into an IRA, not a QRP.

b. The Act provides:

(i) Distributions from IRAs, QRPs, 403(b) plans, and 457 plans may be rolled over to any of the others, except that hardship distributions from 457 plans and 401(k) plans are not eligible for rollover.

(ii) Employee after-tax contributions in a QRP may be rolled over into another QRP, if the recipient plan provides separate accounting for such funds and earnings thereon, or to a traditional IRA. A rollover of an after-tax contribution from one QRP to another must be by direct trustee-to-trustee transfer.

(iii) After-tax contributions still cannot be rolled over from an IRA into a QRP, 403(b) plan or 457 plan.

(iv) A surviving spouse may roll over distributions into a QRP, 403(b) plan or 457 plan in which such spouse participates.

2. Waiver of 60-day Rule

a. Pre-EGGTRA, amounts received from a QRP or IRA may be rolled over tax free if the rollover is made within 60 days of the date of distribution. The Secretary of the Treasury generally has no authority to waive the 60-day rollover period, except during military service in a combat zone or by reason of a Presidentially declared disaster.

b. The Act provides that the Secretary may waive the 60-day rollover period

if the failure to waive such requirement would be "against equity or good conscience," including cases of casualty, disaster, or other events beyond the reasonable control of the individual attempting the rollover.

c. The conference agreement for the Act states that the Secretary may issue guidance that includes objective standards for a waiver of the 60-day period, including a waiver for a period during which the participant has received payment in the form of a check but has not cashed the check, for errors committed by a financial institution, or in the cases of inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error.

Q. FORMS OF DISTRIBUTION AND THE ANTI-CUT BACK RULES: Pre-EGGTRA an amendment to a QRP may not decrease the accrued benefit of a plan participant by eliminating an optional form of benefit.

1. Recent changes to the Regulations allow the elimination of an optional form of benefit for:

(i) DC plans offering a lump sum distribution if the participant receives at least 90 days' advance notice of the elimination, or

(ii) voluntary transfers in connection with mergers, acquisitions or changes in employment status where the change is between DC plans of the same type.

2. the Act provides that a DC plan to which benefits are transferred will not be treated as having impermissibly reduced a participant's or beneficiary's accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if:

(i) the plan receives a direct transfer of the participant's or beneficiary's benefit from another DC plan or the plan results from a merger or other transaction that has the effect of a direct transfer,

(ii) the terms of both the transferor plan and the transferee plan authorize the transfer,

(iii) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the receipt of a notice describing the consequences of making the election, and

(iv) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a lump sum distribution.

These changes are particularly helpful in mergers and acquisitions.

3. The Act also directs the Secretary of the Treasury to provide regulations, no later than December 31, 2002, that specifically provide that many of the existing law's prohibitions in this regard do not apply to amendments that eliminate or reduce benefits to the extent that they would create significant burdens and complexities for a plan and its participants, but only if any such amendment does not adversely affect the rights of participants in more than a "de minimis" manner. For these purposes, de minimis is determined by taking into account a laundry list of factors spelled out in the Act.

R. ELIMINATION OF THE "SAME DESK" RULE:

1. Pre-EGGTRA an employee's "separation from service" triggers distribution of benefits from the plan to the employee.

   a. Separation from service includes cessation of employment by the employer that maintains the plan.

   b. However, a participant's "severance from employment" from a particular employer does not necessarily result in a "separation from service" under the "same desk rule" which applies when the employee continues on the same job for a different employer as a result of certain corporate transactions such as a merger.

2. the Act repeals the same desk rule on distributions from 401(k) plans, 403(b) plans or 457 plans and provides that a distribution may be made upon severance from employment rather than separation from service.

3. The conference agreement for the Act states that the conferees intend that a plan may provide that certain specified types of severance from employment do not constitute distributable events.

   a. For example, a plan could provide that a severance from employment is not a distributable event if such severance would not have constituted a separation from service under the law in effect prior to a specified date.

   b. Furthermore, a plan sponsor that has employees who experienced a severance in employment in the past that was prevented from being treated as a distributable event because of the "same desk rule" now has the option to provide in the plan that such severance from employment would, or would not, be treated as a distributable event under the plan.

c. In addition, in the case of a transfer of plan assets and liabilities relating to any portion of an employee's benefit under a plan of the employee's former employer to a plan maintained or created by such employee's new employer (other than a rollover or elective transfer), such employee will not be considered to have experienced a severance of employment with the employer maintaining the plan that covers the employee.

S. DISREGARDING ROLLOVERS IN APPLYING THE CASH-OUT RULES:

1. Pre-EGGTRA,a QRP may distribute a participant's vested benefit without the recipient's consent ("cash-out") upon that participant's separation from service, only if the present value of such benefit is $5,000 or less. If the value is more than $5,000, distribution can't be made without the participant's consent.

2. The Act provides that a plan determining the present value of a participant's vested benefit for the cash-out rule may disregard that portion attributable to rollover contributions and earnings thereon. Therefore accounts greater than $5,000 may be cashed out if the non-rollover portion of such account does not exceed $5,000.

T. SPECIAL RULES FOR GOVERNMENTAL PLANS

Pre-EGGTRA law provides that amounts deferred under 457 plans are includible in income when paid or made available, and such plans are subject to both the minimum distribution rules applicable to QRPs and special minimum distribution rules applicable to 457 plans.

Pre-EGGTRA law provides that a participant in either a 403(b) or a 457 plan may not use a rollover from such a plan to purchase service credits, which a participant may otherwise be able to make through after-tax contributions.

The Act provides that amounts deferred under a State or local government 457 plan are includible in income when paid. Furthermore, such plans are only subject to the minimum distribution rules applicable to QRPs rather than the special minimum distribution rules previously applicable to such plans.

The Act also provides that a participant is not required to include in gross income a direct trustee-to-trustee transfer of his or her account balance to a governmental DB plan from a 403(b) plan or a 457 plan if the transferred amount is used to purchase permissive service credits under the plan, or to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State). This benefits employees who work for multiple governmental employers during their careers.

U. EASING REGULATORY BURDENS

1. Modification of Timing of Plan Valuations: Pre-EGGTRA law requires DB pension plans to perform annual valuations. Proposed Treasury regulations provide that these valuations are to be performed during the plan year to which the valuation refers or during the month prior to that plan year.

   a. The Act incorporates this rule into the Code.

   b. An exception to the rule provides that pension plans with assets greater than or equal to 100% of the plan's pre-EGGTRA liability may perform the valuation on any date within the plan year immediately preceding the year to which the valuation refers.

   c. A change in the funding method use the exception may not be made unless plan assets are at least 125% of the plan's pre-EGGTRA liability.

2. ESOP Dividends May Be Reinvested Without Loss of Dividend Deduction: Pre-EGGTRA law entitles an employer to deduct certain dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by a qualified employee stock ownership plan ("ESOP").

   a. The deduction is allowed with respect to dividends that are:

      (i) paid in cash directly to the plan participants or beneficiaries,

      (ii) paid to the plan and then distributed to the participants or beneficiaries in cash no later than 90 days after the end of the plan year in which the dividends are paid to the plan, or

      (iii) used to make payments on loans used to acquire the employer securities through which the dividend is paid.

   b. The Act provides that an employer may, in addition to deductions allowed under pre-EGGTRA law, deduct dividends that, at the election of plan participants or beneficiaries, are payable as provided in (i) or (ii) above, or are paid to the plan and reinvested in qualifying employer securities.

   c. The Secretary of the Treasury may disallow the deduction if it is determined that the dividend constitutes an avoidance or evasion of tax or if the amount of the dividend is unreasonable.

3. Employees of Tax-Exempt Entities: Generally, all employees of corporations or trades and businesses whose employees are treated as employed by a single

employer must be taken into account in applying the Code's nondiscrimination rules.

a. The Treasury regulations provide that in applying the nondiscrimination rules to a 401(k) plan, an employer may exclude the employees of tax-exempt entities only if such employees could not participate in the 401(k) plan due to the prohibition on maintenance of a 401(k) plan by tax-exempt entities.

b. The exclusion provided by the regulations became irrelevant when the prohibition on the maintenance of a 401(k) plan by tax-exempt employers was repealed for years beginning in 1997. Accordingly, a controlled group of corporations treated as a single employer that contains both a tax-exempt entity maintaining a 403(b) plan and a taxable entity maintaining a 401(k) plan is required to include all employees of both the tax-exempt and the taxable entities for purposes of the non-discrimination rules, which could result in failing the applicable discrimination test and the need to terminate the 403(b) plan in order to pass such test.

c. The repeal of the prohibition on nongovernmental tax-exempt employers maintaining 401(k) plans made the exception of the pre-EGGTRA regulations obsolete. Thus, there is Pre-EGGTRA no exception available to exclude employees of the tax-exempt entity from a controlled group member's 401(k) plan.

d. The Act resolves this issue by directing the Treasury to revise its regulations to provide that employees of a tax-exempt entity who are eligible to make salary reduction contributions under a 403(b) plan may be treated as excludable employees for purposes of testing a 401(k) plan if:

(i) no employee of the tax-exempt entity is eligible to participate in the 401(k) plan, and

(ii) at least 95% of the employees who are not employees of the tax-exempt entity are eligible to participate in the 401(k) plan.

4. Employer-Provided Retirement Advice: Pre-EGGTRA law provides that certain employer-provided fringe benefits are excludable from gross income and wages for employment tax purposes. These excludable fringe benefits include working condition fringe benefits and de minimis fringes, as well as certain employer-provided educational assistance.

a. There is no specific exclusion for employer-provided retirement planning services. However, such services may be excluded as employer-provided

educational assistance or a fringe benefit.

b. The Act provides that tax-qualified retirement planning services provided to an employee and spouse by an employer maintaining a QRP are excludable from income and wages.

c. The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's QRP.

5. Repeal of the Multiple Use Test: The Code provides that if certain requirements are met, a special nondiscrimination test called the "multiple use test" applicable to 401(k) plans must be satisfied in addition to the actual deferral percentage test and the actual contribution percentage test. The Act repeals the complex multiple use test, which will alleviate the discrimination testing burden on many employers.

V. STRENGTHENING PENSION SECURITY AND ENFORCEMENT

1. Repeal of Pre-EGGTRA Liability Funding Limit: Pre-EGGTRA law provides that no contribution is required to be made to a DB pension plan under the minimum funding rules if such contribution is in excess of the "full funding limit."

a. The full funding limit is defined generally as the excess, if any, of (i) the lesser of (a) 160% (with scheduled increases up to 170% beginning in 2005) of the plan's pre-EGGTRA liability or (b) the accrued liability under the plan, over (ii) the value of the plan assets.

b. Because the pre-EGGTRA full funding limit may result in inadequate funding of plans, the Act revises the pre-EGGTRA liability full funding limit to 165% for the 2002 plan year and 170% for the 2003 plan year. In 2004 and thereafter, the pre-EGGTRA full funding limit is repealed and will be replaced by a determination of the excess of the accrued liability under the plan (including normal cost) over the value of the plan's assets.

2. Maximum Deduction Rules Modified and Applied to All DB Plans: Pre-EGGTRA, an employer sponsoring a DB pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year (up to a maximum amount equal to the full funding limit).

a. Under a special rule, with respect to an employer that sponsors a tax-qualified DB pension plan which has more than 100 participants for

the plan year, the maximum deductible amount is 100% of the plan's unfunded pre-EGGTRA liability.

b. The Act provides that the special rule is extended to all DB pension plans except for plans not covered by the Pension Benefit Guaranty Corporation termination insurance program (i.e., professional service employers with less than 25 participants).

c. For plans that terminate within the plan year, the Act further modifies this special rule by providing that such deduction is for up to 100% of unfunded termination liability, determined taking into account the plan's termination during such plan year.

(i) For plans with less than 100 participants for the plan year, termination liability would not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment which was made or became effective (whichever is later) within the last two years before the termination date.

This gives plan sponsors greater incentive to adequately fund their plans on an accelerated basis.

3. Excise Tax Relief for Sound Pension Funding: Pre-EGGTRA, an employer that makes nondeductible contributions to a QRP is subject to an excise tax equal to 10% of the amount of the nondeductible contributions for the plan year. This 10% excise tax does not apply to contributions to certain terminating DB plans or to contributions of up to 6% of compensation to a DC plan for employer matching contributions and employee elective deferrals.

a. The Act provides that the employer, in determining the amount of nondeductible contributions, is permitted to elect not to take into account contributions to a DB pension plan except to the extent they exceed the accrued liability full funding limit.

b. An employer making such an election for a year would not be permitted to take advantage of the pre-EGGTRA law exceptions for certain terminating plans and certain contributions to DC plans.

4. Protection of Investment of Employee Contributions to 401(k) Plans: ERISA prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities and property exceeds 10% of the fair market value of plan assets.

a. This 10% limitation does not apply to 401(k) plans that specifically authorize such investment, but does apply to the portion of the plan that consists of elective deferrals (and earnings thereon) if more than 1% of any employee's eligible compensation is required to be invested in employer securities and real property. This exception to the exception for required elective deferrals does not Pre-EGGTRA apply with respect to elective deferrals (and earnings thereon) for plan years beginning before 1999.

b. The Act modifies the effective date of this rule by providing generally that the rule does not apply to any elective deferrals used to acquire an interest in employer securities or real property acquired before January 1, 1999.

5. Prohibited Allocations of Stock in an S Corporation ESOP: A 50% excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP and such allocations are includible in the gross income of the individual receiving the prohibited allocation.

a. The Act provides that if there is a non-allocation year (i.e., a year in which disqualified persons own at least 50% of the S corporation) with respect to an ESOP maintained by an S corporation:

(i) the amount allocated in a prohibited allocation to an individual who is a disqualified person is treated as distributed to such individual (i.e., the value of the prohibited allocation is includible in the gross income of the individual receiving the prohibited allocation),

(ii) an excise tax is imposed on the S corporation equal to 50% of the amount involved in a prohibited allocation, and

(iii) an excise tax is imposed on the S corporation with respect to any "synthetic equity" (i.e., an interest that gives the holder the right to acquire stock in the future) owned by a disqualified person.

b. The Act also authorizes the Secretary of the Treasury to issue guidance clarifying that a non-allocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes, in substance, an avoidance or evasion of the prohibited allocation rules.

c. This provision is generally effective with respect to plan years beginning after December 31, 2004. In the case of an ESOP established after March 14, 2001, or an ESOP established on or before such date if the employer maintaining the ESOP was not an S corporation on such date, the amendment is effective with respect to plan years ending after March 14, 2001.

6. Automatic Rollovers of Certain Cash-out Distributions: Pre-EGGTRA, if a participant ceases to be employed, a QRP may generally distribute the participant's vested benefit without the consent of the participant if the present value of the benefit does not exceed $5,000.

   a. The Act makes direct rollovers the default option for cash-out distributions that exceed $1,000 and that are eligible rollover distributions from QRPs.

   b. Such distribution would be rolled over automatically to a designated IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or another QRP or to receive it directly.

   c. The plan administrator must provide written notice to the participant explaining that an automatic direct rollover will be made unless the participant elects otherwise, and that the distribution may be transferred without cost to another IRA.

   d. The Act also amends the fiduciary rules of ERISA so that, in the case of an automatic direct rollover, the participant is treated as exercising control over the assets in the IRA upon the earlier of (i) the rollover of any portion of the assets to another IRA or (ii) one year after the automatic rollover.

   e. The Act directs the Secretary of Labor to issue safe harbors pertaining to fiduciary requirements applicable to the designation of an institution and investment of funds. The provision of the Act will be effective after the Department of Labor has adopted final regulations implementing such provision, which must be adopted not later than three years after the Enactment Date.

7. Notice of Significant Reduction in Plan Benefit Accruals: Pre-EGGTRA, ERISA Sec. 204(h) provides that if a DB plan or a MP plan is amended to provide for a significant reduction in the rate of future benefit accrual, the plan administrator must provide a written notice summarizing such amendment and specifying its effective date at least 15 days before the effective date of the amendment.

   a. The Act expands this notice requirement. For most DB and MP plans, plan administrators must furnish, within a reasonable time, a written notice explaining any plan amendment providing for a significant reduction in the rate of future benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy.

   b. The notice must be written in an understandable fashion, and must be provided to each plan participant (including an alternate payee) whose rate of future benefit accrual may reasonably be expected to be significantly

reduced by the plan amendment.

c. Willful failure to provide such notice may result in an excise tax equal to $100 per day per omitted participant, subject to certain maximums and exceptions.

d. The Act authorizes the Treasury Secretary to issue regulations providing simplified notice requirements or exemptions in cases where participants are given the opportunity to choose between benefits under the new plan formula versus the old plan formula.

e. This provision is effective for plan amendments taking effect on or after the Enactment Date. Prior to the issuance of Treasury regulations, a plan will be treated as meeting the requirements of this provision if the plan makes a "good faith effort" to comply with such requirements. The period for providing the notice will not end before the last day of the three-month period beginning after the Enactment Date.

f. This change will apply to conversions of DB plans to cash balance plans.

W. IRA CHANGES

1. Increased Annual Contribution Limits: Pre-EGGTRA, an individual may contribute up to $2,000 per year to an IRA. The limit has not been increased for years.

a. The Act increases the maximum annual dollar contribution limit to traditional and Roth IRAs to:

(i) $3,000 for the years 2002 through 2004;

(ii) $4,000 for the years 2005 through 2007; and

(iii) $5,000 for the year 2008.

b. Thereafter, the limit will be adjusted annually for inflation in increments of $500.

c. The Act also allows individuals who have attained age 50 during a taxable year to make additional "catch-up" contributions with respect to such year. The otherwise applicable limit for such individuals, prior to application of the AGI limits, is increased by

(i) $500 for the years 2002 through 2005; and

(ii) $1,000 for the year 2006 and thereafter.

2. Deemed IRA's Under QRPs: Effective for plan years beginning after December 31, 2002, the Act provides that:

a. if an eligible retirement plan permits a participant to make voluntary employee contributions to a separate account or annuity that

(i) is established under such retirement plan, and

(ii) meets the requirements of a traditional or a Roth IRA, then the separate account or annuity is deemed to be a traditional or Roth IRA, as applicable.

b. Such "deemed IRAs" are not subject to the rules under the Code pertaining to the underlying plan or to the general provisions of ERISA; however, the exclusive benefit and fiduciary provisions of ERISA apply, to the extent that they apply to the underlying plan.