Covington & Burling

1201 PENNSYLVANIA AVENUE NW
WASHINGTON, DC 20004-2401
TEL 202.662.6000
FAX 202.662.6291
WWW.COV.COM

WASHINGTON
NEW YORK
LONDON
BRUSSELS
SAN FRANCISCO

June 1, 2001

EMPLOYEE BENEFIT PROVISIONS OF THE NEW TAX LAW OFFER OPPORTUNITIES TO EMPLOYERS

The recently-passed tax bill offers employers significant opportunities to improve their employee benefit plans, particularly their § 401(k), pension, and profit-sharing plans. The bill, entitled the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act"), should be signed by the President shortly.

Although some changes are phased in, most provisions become effective next year. As a result, employers will need to move quickly to determine how to respond to the Act's employee benefit provisions.

In addition, while many of the Act's provisions offer opportunities, some provisions impose new requirements. For example, the Act creates new disclosure rules for amendments that reduce future pension benefits. Any employer contemplating amendments to its pension plan will need to give attention to the new disclosure requirements.

All provisions of the Act, including the employee benefit provisions, expire on December 31, 2010.

In this memorandum, we identify the employee benefit provisions likely to be of greatest interest to most private-sector employers. The Act also includes a number of employee benefit provisions that are not identified in this memorandum, including provisions relating to governmental and tax-exempt employers, ESOPs maintained by S corporations, and multiemployer plans.

We will be pleased to help our clients address any questions they have about any of the Act's employee benefit provisions.

HIGHLIGHTS

- Higher limits on contributions, benefits, and includible compensation
- Catch-up contributions
- IRA accounts within qualified plans
- Greater benefit portability
- Repeal of the "same desk" rule
- Liberalization of ESOP dividend deduction
- New disclosure requirements for plan amendments
- Faster vesting of matching contributions
- New hardship withdrawal rules

Higher Plan Limits

- **Qualified Defined Benefit Plan Limits:** The Act increases the dollar limit on annual benefits from $140,000 to $160,000, subject to future indexing in $5,000 increments, in accordance with current law. The limits for early and late retirement are also made more generous: the dollar limit is reduced only if benefits start before age 62, while the limit is increased if benefits start after age 65. Effective for years ending after December 31, 2001.
- **Qualified Defined Contribution Plan Dollar Limit:** The dollar limit on annual contributions is increased from $35,000 to $40,000, with more rapid future indexing (in $1,000 increments rather than the current $5,000 increments). Effective for years beginning after December 31, 2001.
- **Qualified Defined Contribution Plan Percentage Limit:** The Act increases from 25% to 100% the percentage-of-compensation limit on annual contributions. Effective for years beginning after December 31, 2001.
- **Qualified Plan Compensation Limit:** The limit on eligible compensation is increased from $170,000 to $200,000, with future indexing in $5,000 increments (rather than the current $10,000 increments). Effective for years beginning after December 31, 2001.
- **§ 401(k) Dollar Limit:** The limit on § 401(k) contributions is increased from $10,500 to $11,000 in 2002. Beginning in 2003, the limit is increased in $1,000 annual increments until the limit reaches $15,000 in 2006, with future indexing in $500 increments. Similar changes are made to the limits on contributions to § 403(b) annuities, § 457(b) plans, and other elective plans.
- **Catch-Up Contributions to Qualified Plans:** An additional increase in the dollar limit on § 401(k) contributions and other pre-tax elective contributions allows individuals age 50 or older to make catch-up contributions. For § 401(k) plans, the increase in the dollar limit starts at $1,000 in 2002 and increases by $1,000 for each subsequent year until it reaches $5,000 for 2006, with future indexing in $500 increments. Catch-up contributions are not subject to any other contribution limits and are not subject to nondiscrimination testing. However, the plan must allow all eligible participants to make the same catch-up contribution election; all plans of related employers are treated as a single plan for this purpose.
- **Multiple Use Test:** The Act repeals the multiple use test, which applies to highly compensated employees who participate in plans that allow both § 401(k) contributions and after-tax or matching contributions. Effective for years beginning after December 31, 2001.
- **IRA Contribution Limits:** The IRA contribution limits are increased gradually, to $3,000 for 2002–2004, $4,000 for 2005–2007, and $5,000 for 2008 and later years, subject to future indexing in $500 increments. Catch-up IRA contributions are permitted for individuals age 50 or older in annual amounts starting at $500 in 2002–2005 and increasing to $1,000 in 2006 and thereafter.
- **Deemed IRAs under Qualified Plans:** Employers may permit employees to make voluntary contributions to deemed traditional IRA accounts and deemed Roth IRA accounts under qualified plans. Effective in years beginning after December 31, 2002.

Portability

- **More Rollover Options:** Eligible rollover distributions from qualified plans, § 403(b) annuities, and governmental § 457(b) plans can be rolled over to any of such plans as well as to an IRA. IRA distributions can be rolled over into a qualified plan, § 403(b) annuity, governmental § 457(b) plan, or another IRA. A distribution to an individual from a qualified plan will not be eligible for capital gain or averaging treatment, however, if the same individual previously made a rollover to the plan that would not have been permitted under prior law. Employers must revise the rollover notice to reflect the new rules. Effective for distributions after December 31, 2001.
- **Rollover of After-Tax Contributions:** Employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. Effective for distributions after December 31, 2001.
- **Waiver of 60-Day Rollover Rule:** The Treasury may waive the 60-day rollover period if the failure to waive the 60-day period would be against equity or good conscience. Effective for distributions after December 31, 2001.
- **Elimination of Optional Forms of Distribution under Defined Contribution Plans:** If a participant or beneficiary makes a voluntary election to transfer an account from one defined contribution plan to another, and if certain other requirements are satisfied, the receiving plan is no longer required to provide all of the forms of distribution previously available under the transferor plan. In addition, an employer may amend a defined contribution plan to eliminate a form of distribution, provided that (1) a single sum distribution is available at the same time or times as the eliminated form of distribution, and (2) the single sum distribution applies to a portion of the participant's account at least as great as the portion that was eligible for the eliminated form of distribution. (The new rules permitting the elimination of distribution options are less restrictive in certain respects than similar rules recently included in Treasury regulations.) Effective for years beginning after December 31, 2001.
- **Elimination of Optional Forms of Distribution under Defined Benefit and Defined Contribution Plans:** The Treasury is directed to issue regulations providing that the prohibitions against eliminating or reducing an early retirement benefit, a retirement-type subsidy, or an optional form of benefit do not apply to amendments that eliminate benefits, subsidies, or optional forms that create significant burdens and complexities for the plan and its participants, but only if the amendment does not adversely affect the rights of any participant in more than a de minimis manner. (An example in the Joint Explanatory Statement indicates that this rule could be used to eliminate one of two similar benefits after a plan merger.) The Treasury is directed to issue final regulations by December 31, 2003.
- **Repeal of the "Same Desk" Rule:** The Act repeals the "same desk" rule, which generally prohibited a § 401(k) plan from distributing an employee's account when the employee continued in the same job for a successor employer after a business sale. (The Act uses the term "severance from employment" to describe changes in employment status that may trigger distributions under the new rule.) The repeal is effective for distributions after December 31, 2001, even if the severance from employment occurred many years earlier. A plan may provide, however, that specified types of severance from employment are not distributable events. If a portion of the employee's benefit is transferred (other than by

rollover or elective transfer) to a plan sponsored by the employee's new employer, the employee is not deemed to have severed from employment.

- **Mandatory Cash-Outs:** For purposes of the rule that permits mandatory cash-out of a benefit whose value is $5,000 or less, a plan may provide that the present value of a participant's benefit is determined without regard to any portion attributable to rollover contributions (and allocable earnings). Effective for distributions after December 31, 2001.

- **Automatic Rollovers of Mandatory Cash-Outs:** A direct rollover to an IRA must be the default option for mandatory cash-outs exceeding $1,000. Effective for distributions after the Labor Department issues final regulations prescribing fiduciary safe harbors for choosing an institution to receive the rollover or designating investment funds. The final regulations must be issued within 3 years after enactment.

- **Hardship Withdrawals:** The Treasury is directed to revise its regulations to reduce from 12 to 6 months the period during which an employee's contributions must be suspended following a hardship withdrawal. The regulations are to be effective after December 31, 2001. In addition, no hardship distribution is an eligible rollover distribution (even if the distribution is not subject to § 401(k) restrictions), effective after December 31, 2001.

Disclosure to Participants

- **Notice of Significant Reduction in Benefit Accruals:** The Act amends the Internal Revenue Code to require the administrator of a defined benefit pension plan or a money purchase pension plan to give advance written notice of a plan amendment that provides for a significant reduction in the rate of future benefit accrual. Unlike the requirement under current law, the new notice requirement also applies to any elimination or reduction of an early retirement benefit or retirement-type subsidy. The notice must include sufficient information to allow participants to understand the effect of the amendment and must be provided within a reasonable time before the effective date of the amendment. A plan administrator that fails to comply with the notice requirement is subject to an excise tax. The Act also amends ERISA § 204(h) to provide that a plan amendment may not significantly reduce the rate of future benefit accrual in the event of an egregious failure by the plan administrator to comply with a notice requirement that is similar to the notice requirement in the Code. Effective for plan amendments taking effect on or after the date of enactment; however, the period for providing any required notice will not end before the last day of the 3-month period following the date of enactment. A good faith standard of compliance applies before the issuance of Treasury regulations.

ESOPs

- **ESOP Dividend Deduction:** In addition to dividend-deduction provisions under current law, an employer may deduct dividends that, at the election of ESOP participants or beneficiaries, are paid to the plan and reinvested in qualifying employer securities. The Treasury is authorized to disallow the deduction for any ESOP dividend that constitutes the avoidance or evasion of taxation. Effective for taxable years beginning after December 31, 2001.

Cash Balance and Other Hybrid Plans

- **Treasury Report:** The Treasury is directed to prepare a report, within 60 days after the date of enactment, on the effects of conversions of traditional defined benefit plans to cash balance or hybrid formula plans, including the effect of conversions on longer-service participants and the effects of wear-away transition benefits.

Pension Funding

- **Full Funding Limit:** The current-liability full funding limit is increased to 165% of current liability for plan years beginning in 2002 and to 170% of current liability for plan years beginning in 2003, and then is repealed for plan years beginning on or after January 1, 2004. If a plan terminates, the employer may deduct a contribution equal to the plan's unfunded termination liability. Effective for plan years beginning after December 31, 2001.
- **Excise Tax on Nondeductible Contributions:** For purposes of the 10% excise tax on nondeductible contributions, an employer may elect to take into account only contributions exceeding the accrued-liability full funding limit. If an employer makes this election, it loses the benefit of certain exceptions that are available under current law. Effective for years beginning after December 31, 2001.
- **Timing of Plan Valuations:** The Act codifies the proposed regulation generally requiring plan valuations to be made as of a date within the applicable plan year or within the immediately preceding month. The Act also includes an exception that permits the valuation date to be any date within the preceding plan year if, as of that date, the value of the plan's assets is not less than 100% of the plan's current liability. Effective for plan years beginning after December 31, 2001.

Other Changes in Qualified Plan Rules

- **Faster Vesting of Matching Contributions:** Employer matching contributions must vest at least as fast as under one of two schedules: (1) 100% vesting after 3 years of service, or (2) 20% after 2 years of service and an additional 20% per year thereafter, with 100% vesting after 6 years of service. Effective for contributions for plan years beginning after December 31, 2001, with a delayed effective date for collectively bargained plans.
- **Option to Treat Pre-Tax Contributions as After-Tax Contributions:** A § 401(k) plan (or a § 403(b) annuity plan) is allowed to include a "qualified Roth contributions program" that permits a participant to have all or part of his future elective contributions treated as after-tax Roth contributions. A qualified distribution of contributions and related investment earnings from a Roth contribution account is not included in gross income. Effective for taxable years beginning after December 31, 2005.
- **Small Employer Tax Credit:** The Act provides a nonrefundable tax credit for a small business that adopts a new qualified defined benefit plan or defined contribution plan, SIMPLE plan, or simplified employee pension. The credit applies to 50% of the first $1,000 in administrative and retirement-education expenses for the plan for each of the plan's first 3 years. Effective for costs paid or incurred in taxable years beginning after December 31, 2001, with respect to plans established after that date.

- **Individual Tax Credit:** The Act provides a temporary nonrefundable tax credit for contributions to a qualified plan made by certain lower-income taxpayers, including contributions to § 401(k) plans. The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the taxpayer's adjusted gross income ("AGI"). Only joint returns with AGI of $50,000 or less, and single returns with AGI of $25,000 or less are eligible for the credit. Effective in taxable years beginning after December 31, 2001, and before January 1, 2007.

- **Deduction Limits:** The annual deduction limit for profit sharing and stock bonus plans is increased from 15% to 25% of compensation, and a money purchase pension plan is treated like a profit sharing or stock bonus plan for deduction purposes. Under the Act, § 401(k) contributions are not subject to the qualified plan deduction limits, and do not count against the limits in determining whether other contributions are deductible. In addition, the participant compensation used to calculate the deduction limits includes salary reduction contributions that are treated as compensation for § 415 purposes. Effective in years beginning after December 31, 2001.

- **Age 70½ Minimum Distribution Rules:** The Treasury is directed to revise the life expectancy tables used to calculate required minimum distributions to reflect current life expectancy, effective on date of enactment.

- **Plan Loans:** The Act eliminates the special restrictions for plan loans to owner-employees, and makes such loans subject to the general statutory exemption for plan loans. Effective in years beginning after December 31, 2001.

- **Top-Heavy Rules:** The Act makes a number of changes in the top-heavy rules, such as amending the definition of "key employee," establishing an exemption for plans meeting the nondiscrimination safe harbors for § 401(k), after-tax, and matching contributions, and allowing matching contributions to count toward the minimum top-heavy contribution requirement. (Changes in the key employee definition will also affect funding limits for post-retirement life and medical benefits and other provisions that incorporate the definition by reference.) Effective after December 31, 2001.

Fringe Benefits

- **Employer-Provided Retirement Advice:** The value of qualified retirement planning services provided to an employee and his or her spouse by an employer with a qualified plan is excluded from income and wages. The exclusion does not apply 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 qualified plans. However, the Treasury may allow employers to provide certain advice only to individuals nearing retirement age under the plan. Effective for years beginning after December 31, 2001.

- **Employer-Provided Education Assistance:** The Act extends the exclusion for employer-provided educational assistance to graduate education and makes the exclusion permanent (subject to the Act's general sunset provision). Effective for courses beginning after December 31, 2001.

Sunset Provision

- **Expiration Date:** The Act provides that its provisions and amendments do not apply to taxable, plan, or limitation years beginning after December 31, 2010, and that the Internal Revenue Code and ERISA shall be applied to such years as if the Act had not been enacted.

The lawyers in Covington & Burling's Employee Benefits Group play a leading role in advising and representing employers in employee benefits matters. We frequently appear before the Congress, federal agencies, and federal courts to resolve major issues of law, policy, and finance. Our employee benefits practice covers all types of benefit arrangements, from pension, profit-sharing, and stock bonus plans (including 401(k) plans, ESOPs, and multiemployer plans), to medical, life insurance and other welfare benefit arrangements, as well as executive compensation and incentive programs.

Senior Lawyers in Covington & Burling's Employee Benefits Group

John M. Vine	Amy N. Moore	Richard C. Shea	Julie M. Edmond
Washington	Washington	Washington	Washington
202.662.5392	202.662-5390	202.662.5599	202.662.5123
jvine@cov.com	anmoore@cov.com	rshea@cov.com	jedmond@cov.com

This memorandum provides general information, not legal advice as to any specific matter. It should not be used as a substitute for appropriate legal advice.

www.cov.com

© 2001 Covington & Burling