ANALYSIS OF THE KEY PENSION AND BENEFIT PROVISIONS IN THE WORKING FAMILIES TAX RELIEF ACT OF 2004

On September 23, 2004, Congress passed the Working Families Tax Relief Act of 2004 ("2004 Act"). The Act, which grew out of an effort to defer scheduled reductions in tax breaks for individuals, turned into a robust extenders and simplification package. Here is an analysis of the 2004 Act's key pension and health benefit provisions.

- **Spousal rollover and rollover explanation rules extended to 403(a) qualified annuities.**

  The 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) greatly expanded the rules governing rollovers from qualified plans, to allow rollovers among various types of qualified retirement plans. Due to these changes, an individual can now roll over distributions from a tax-sheltered annuity tax-free to any eligible retirement plan. In so doing, however, Congress did not include in the annuity rules either: (a) a reference to the rollovers allowable where a surviving spouse gets the employee's distribution, or (b) a reference to the requirement that plan administrators provide written explanations to recipients of distributions that are eligible to be rolled over to another qualified plan or IRA.

  ***New Law*:** The Act would correct these two oversights by referencing in the qualified annuity rollover rules both the spousal rollover rule and the written explanation requirement.

  ***Effective*:** Distributions made after December 31, 2001.

  > **Observation:** The 2004 Act provides that the amendments made take effect as if included in EGTRRA. EGTRRA provides that the amendments take effect for distributions after December 31, 2001.
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  > **Observation:** Under the sunset provision of EGTRRA, the above provision won't apply to tax plan or limitation years beginning after December 31, 2010.

- **Pre-2004 plan year interest rate relief for determining unfunded vested benefits extended to PBGC notice and reporting requirements.**

  To provide relief for plan sponsors from some of the consequences of the low yield on 30-year bonds, the 2002 Job Creation Act, among other amendments, made changes to the PBGC variable rate premiums rules in ERISA. For plan years beginning after December 31, 2001, and before January 1, 2004, the interest rate used in determining the amount of unfunded vested benefits for variable rate premium purposes increased from 85% to 100% of the interest rate on existing 30-year Treasury securities for the month preceding the month in which the plan year began.

Members of a controlled group must file single-employer plan actuarial information and company financial information with PBGC if the aggregate unfunded vested benefits in plans maintained by members of the controlled group exceed $50 million (disregarding plans with no unfunded vested benefits). This computation is made using the variable rate premium interest rate. The 2002 Job Creation Act did not change the interest rate for purposes of this rule, so the rate remained at 85% of the Treasury yield.

Plan administrators and contributing sponsors must notify PBGC within 30 days after they know or have reason to know a reportable event has occurred ("post-event notice"). DOL regulations waive reporting for several of these events if certain criteria are met. Several of the waiver criteria are tied to the variable rate premium calculation the 2002 Job Creation Act did not change the interest rate for purposes of this rule, so the rate remained at 85% of the Treasury yield.

A non-public company must give PBGC notice at least 30 days before the effective date of certain events ("advance notice") if:

(1) the aggregate unfunded vested benefits of plans maintained by members of the controlled group exceeds $50 million (disregarding plans with no unfunded vested benefits), and

(2) the aggregate funded vested benefit percentage for the underfunded plans is less than 90%.

Vested benefits for both the $50 million and the 90% funding percentage threshold tests are computed using the variable rate premium interest rate. The 2002 Job Creation Act did not change the interest rate for purposes of this rule, leaving the rate at 85% of the Treasury rate.

Administrators of certain underfunded PBGC-insured plans are required to issue a "participant notice" stating what the plan's funded current liability percentage is, and describing the limitations on PBGC's guarantee. Plans for which a variable rate premium is not required for a plan year are not required to issue a participant notice for that plan year.

The 2002 Job Creation Act did not allow use of the 100% of Treasury yield rates to determine whether a plan must issue a participant notice. Thus, plans had to continue to use the 85% of Treasury yield rate for this purpose.

> **Observation:** Thus in sum, the Treasury yield relief provided by the 2002 Job Creation Act did not extend to the PBGC's notice and reporting provisions.
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> **Observation:** In technical Update 02-1, PBGC used its waiver authority to extend the 2002 Job Creation Act's interest rate relief to annual reporting and to post-event and advance reporting. PBGC could not extend the interest rate relief to the participant notice rules, however, so the 85% of Treasury yield rate continued to apply to the notice rules.

New law: To extend the 2002 Job Creation Act's interest rate relief to PBGC's notice and reporting provisions, the 2004 Act would make a conforming change to ERISA so the interest rate relief applies.

Thus, the interest rate relief provided by the 2002 Job Creation Act would apply to the notice and reporting rules for underfunded plans.

Effective: For PBGC notice and reporting provisions for plan years beginning after December 31, 2001, and before January 1, 2004.

> **Observation:** The 2004 Act provides that the amendments made take effect for plan years beginning after December 31, 2001, and before January 1, 2004.

- **Exception to excise tax on nondeductible contributions made to a qualified plan is not limited by amount of 401(k) plan elective deferrals.**

If an employer makes a nondeductible contribution to a qualified retirement plan, the amount in excess of the deduction limit is subject to a 10% excise tax.

In determining the amount of nondeductible contributions subject to the excise tax, the Code provides an exception to the excise tax under which some contributions do *not* have to be taken into account where the contributions are: (1) made to one or more defined contribution plans, and (2) not deductible solely because of the limitation on deductions to a combination of defined contribution and defined benefit plans. The exception is subject to a limit, which is based on a formula that includes the amount of elective deferrals (i.e., an employee's salary deferrals) to a 401(k) plan.

EGTRRA provided that (1) the deduction limits for employer contributions to qualified plans do not apply to elective deferrals, and (2) elective deferrals are not taken into account in applying the deduction limits to any other employer contributions.

New Law: The 2004 Act would conform the Code excise tax exception to EGTRRA by eliminating 401(k) plan elective deferrals from the calculation of nondeductible contributions.

Effective: For years beginning after 2001. (2004 Act §404(f)).

> **Observation:** 2004 Act §404(f) provides that the above provision is effective as if included in the EGTRRA provision to which the above rules relate. The above rules relate to EGTRRA §614 which, under EGTRRA §614(B), is effective for years beginning after 2001.

> **Observation:** Under EGTRRA's sunset provision, the above provision will *not* apply to any tax, plan or limitation year beginning after 2010.

- **Domestic workers' wages are treated as compensation for SIMPLE plan contribution purposes.**

Employer contributions to qualified retirement plans on behalf of employees are generally deductible. However, contributions to plans for domestic, household or similar workers are *not* deductible because the contributions are not made in connection with a trade or business of the employer. Nondeductible plan contributions are subject to a 10% excise tax, unless an exception applies.

EGTRRA provided that contributions to a SIMPLE IRA plan or a SIMPLE 401(k) plan, which are not deductible when contributed solely because the contributions were not made in connection with a trade or business of the employer, are *not* taken into account for purposes of the 10% excise tax on nondeductible contributions to a qualified plan. Thus, employers of household workers who make contributions to SIMPLE plans are not subject to the excise tax, even though those contributions are nondeductible.

For purposes of determining contributions to a SIMPLE plan, an employee's compensation must be taken into account. For this purpose, compensation includes the employee's total wages for income tax withholding purposes. Wages paid to domestic workers, however, are not subject to income tax withholding. Thus, when EGTRRA amended the Code to allow SIMPLE plan contributions on behalf of domestic workers without triggering the excise tax, it did not also modify the definition of compensation to include domestic workers' wages.

> **Observation:** Without this modification, no contribution to a SIMPLE plan could be made for a domestic worker, because technically, a domestic worker must have "wages" before any SIMPLE plan contribution can be made on his behalf.

New Law: The 2004 act would revise the definition of compensation to allow for SIMPLE plan contributions on behalf of domestic workers. The 2004 Act would accomplish this by providing that, for purposes of determining compensation, the amount of an employee's total wages for income tax withholding purposes is determined without regard to the rule that wages paid to domestic workers are not subject to income tax withholding. Thus, for purposes of determining contributions to a SIMPLE plan, the definition of compensation would include wages paid to domestic workers even though these amounts are not subject to income tax withholding.

Effective: For tax years beginning after 2001.

> **Observation:** 2004 Act provides that the above provision is effective as if included in the EGTRRA provision to which the above rules relate. The above rules relate to EGTRRA, and is effective for tax years beginning after 2001.

> **Observation:** Under EGTRRA's sunset provision, the above provision will *not* apply to any tax, plan, or limitation year beginning after 2010.

- **Obsolete provision relating to minimum participation rules repealed.**

The 1996 Small Business Act amended the Code minimum participation rules (which generally require that a qualified retirement plan benefit the lesser of 50 employees or 40% of the employer's workforce) so these rules apply *only* to defined *benefit* plans. However, the 1996 Small Business Act failed to repeal portions of the Code which treated employees who were merely eligible to contribute to 401(k) or 401(m) plans as plan participants under these rules. Since 401(k) plans and 401(m) plans are both defined *contribution* plans no longer subject to the participation rules, this provision became obsolete.

New law: The 2004 Act would repeal the obsolete Code provision referencing 401(k) and 401(m) plans.

Effective: Years beginning after December 31, 1996.

> **Observation:** 2004 Act provides that the above repeal is effective as if included in the provision of the 1996 Small Business Act to which the above repeal relates. The above repeal relates to 1996 Small Business Act, which, is effective for years beginning after December 31, 1996.

- **Medicare+Choice MSA is renamed "Medicare Advantage MSA."**

Individuals who are eligible for Medicare are permitted to choose either the traditional Medicare program or, what was named under pre-2004 Working Families Act law, a Medicare+Choice medical savings account ("Medicare+Choice MSA").

New law: Medicare+Choice MSAs would be renamed "Medicare Advantage MSAs".

> **Observation:** The name change to Medicare Advantage MSA does not change the substance of the program.

Effective: Date of enactment.

- **Archer MSA program is extended through 2005-trustees' reports for 2004 will be timely if made with 90 days of enactment.**

Archer Medical Savings Accounts (Archer MSAs) provide a tax-favored way to save for and pay medical expenses. Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an eligible individual, and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not includible in gross income. Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and to self-employed individuals covered under a high deductible health plan.

The number of taxpayers benefitting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). To date, the number of Archer MSAs established has not exceeded the threshold level.

No new Archer MSAs may be established after the close of the "cut-off year". Under pre-2004 Act law, the "cut-off year" was defined as the earlier of:

- calendar year 2003, or

- the first calendar year before 2003 for which IRS could have determined that the numerical limitation for the year had been exceeded.

Thus, under pre-2004 Act law, no new contributions could be made to Archer MSAs after 2003, except by or on behalf of individuals who previously had Archer MSA contributions, and employees who are employed by a participating employer.

Every trustee of an Archer MSA is required to make an annual report to IRS specifying the number of Archer MSAs of which he is trustee, and providing various other information. Under pre-2004 Act law, the report for an Archer MSA established by July 1st of any year was due by August 1st of that year.

Under pre-2004 Act law, IRS was required to make and publish the determination that a year is a "cut-off year" by October 1st of that year.

If the IRS determines that the Archer MSA program ends early because the numerical limitation on Archer MSAs has been reached, then an individual who is not covered by a high deductible health plan by the "cut-off date" will be unable to establish an Archer MSA. Under pre-2004 Act law, the cut-off date was October 1st of the cut-off year.

New Law: The 2004 Act would extend Archer MSAs through 2005 by amending the definition of "cut-off year" by replacing "2003" with "2005" in each place that "2003" appeared.

Reports required from Archer MSA trustees for 2004, which, under pre-2004 Act law, would have been due on August 1, 2004, will be treated as timely if made before the end of the 90-day period beginning on date of enactment.

If IRS determines that 2004 is a cut-off year, IRS may make and publish that determination, which, under pre-2004 Act law, IRS would have been required to do by October 1, 2004, at any time before the close of the 120-day period beginning on date of enactment. If IRS determines that 2004 is a cut-off year, then the "cut-off date" will be the last day of the 120-day period beginning on date of enactment.

Effective: January 1, 2004.

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