August 7, 2001

# MAJOR EMPLOYEE RETIREMENT PLAN CHANGES IN THE 2001 TAX ACT

Although the 2001 Act's tax rate cuts and estate and gift tax changes have received top billing in the media, the many retirement plan changes in the new law deserve at least equal attention. Virtually every important dollar figure and percentage limit has been increased and many other favorable changes have been made. The net result is beginning next year, many employees who are covered by a company retirement plan will have better tools with which to build a secure retirement future. That includes CEOs of major corporations, owner-employees of closely held corporations, middle managers and regular employees, including those in the lower-paid group.

Here's a roundup of how the 2001 Tax Act will help employees build a more financially secure retirement future.

## # HIGHLY PAID EMPLOYEES

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

> Example. A corporation's profit-sharing plan contributes 10% of each participating employee's salary to his or her plan account. One of its employees earns $250,000. This year, the corporation can contribute $17,000 to his account (10% of $170,000). Next year, its contribution for the employee will be $20,000 (10% of $200,000).

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

... This year, the maximum amount that can be contributed to each participant's account is 25% of compensation or, if less, $35,000. The maximum deductible contribution is 15% of the compensation paid to all employees covered by the plan.

... Next year, the maximum that can be contributed to each participant's account is 100% of compensation capped at $40,000. The maximum deductible contribution will be 25% of the compensation paid to all employees covered by the plan.

> Example. An architect has an incorporated practice which maintains a profit-sharing plan. He is the only employee and his annual compensation is $160,000. This year, the practice may contribute $35,000 to the architect's

account (since that figure is less than 25% of his compensation), but it may deduct only $24,000 of the contribution (15% of $160,000). Next year, it can contribute and deduct $40,000 (25% of $160,000).

Companies that maintain regular pension plans (those that pay a fixed annual or monthly amount when the employee retires) will be able to make larger pension payments. The maximum pension a plan can fund is 100% of a participating employee's average compensation for his three highest-paid years, limited by a dollar cap. This year, the dollar cap is $140,000, but next year it will rise to $160,000.

**# REGULAR WAGE EARNERS**

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

(1) There's a limit on how many pre-tax wage dollars you can defer each year. This year, the maximum is $10,500, but it will rise to $11,000 in 2002, and then rise in $1,000 annual increments until it reaches $15,000 in 2006. (These maximums also apply to 403(b) annuities and salary reduction SEPs (Simplified Employee Pensions)).

(2) A new concept called "catch-up" contributions will allow employees who are 50 or older to make additional annual deferrals of pre-tax dollars. The maximum catch-up contribution for 401(k) plans (as well as for 403(b) annuities and salary reduction SEPs) will be $1,000 for 2002, $2,000 for 2003, $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006 and later years. As a bonus, the catch-up contribution will not be subject to the various limitations and requirements that normally apply to elective deferrals.

Example. A company's 401(k) plan allows employees to make elective deferrals up to 10% of compensation or the annual dollar limit, whichever is less. One of its employees, age 51, makes $70,000 a year. Next year, she can make a regular elective deferral of $7,000, plus an additional elective deferral of $1,000. For 2006, she can make an additional elective deferral of $5,000.

(3) Beginning next year, an employee's elective deferrals to a 401(k) plan will not be subject to the deduction limits for stock bonus and profit sharing plans (this year, they are subject to the generally applicable deduction limits). This will make it feasible for companies to allow employees to make larger elective deferrals (or to increase the company contribution).

(4) Beginning next year, elective deferrals (as well as an employee's elective set-asides in a cafeteria plan) will be treated as "compensation" for purposes of applying the deduction limits that apply to profit-sharing and stock bonus plans (as well as some other types of plans, such as employee stock ownership plans (ESOPs). This year, these deferrals are not treated as "compensation."

Example. A company maintains a profit-sharing plan. It also has a 401(k) plan that allows employees to make elective deferrals up to 6% of salary. One of its employees earns $50,000 and makes a maximum 401(k) elective deferral of

$3,000. (We'll assume all the other employees also make the maximum deferral.) Beginning next year, the company can deduct up to $12,500 for (1) contributions to the employee's profit-sharing account, plus (2) matching contributions to her 401(k) account ($12,500 is 25% of $50,000). This year, the company can deduct no more than $7,050 in profit-sharing and matching 401(k) contributions ($7,050 is 15% of [$50,000 minus $3,000 elective contribution]).

(5) Any matching contributions your company makes to your 401(k) account will have to vest at a faster pace. Currently, you must be 100% vested in matching contributions after (1) five years of service or (2) after seven years, if you're 20% vested after three years, plus an additional 20% for each subsequent year. For next year's contributions, you must be 100% vested in matching contributions after (1) three years of service or (2) after six years (20% vested after two years, plus an additional 20% for each subsequent year).

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

# **LOWER-INCOME EMPLOYEES**

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

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

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