VEDDER PRICE

Employee Benefits Bulletin

A review and analysis of recent developments affecting employee benefits

If you have any questions regarding material in this issue of the *Employee Benefits Bulletin* or suggestions for a specific topic you would like addressed in a future issue, please contact the editor, Thomas G. Hancuch at 312/609-7824 or at thancuch@vedderprice.com, or Paul F. Russell *(practice leader)* at 312/609-7740 or at prussell@vedderprice.com or any other Vedder Price Attorney with whom you have worked.

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SPECIAL REPORT

PENSION REFORM ENACTED:
Planning Opportunities and Compliance Obligations

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), recently signed into law by President Bush, makes numerous changes to the rules governing qualified retirement plans under the Internal Revenue Code (Code) and the Employee Retirement Income Security Act (ERISA). One of the primary thrusts of these changes is to enhance the ability of employers to help their employees save for retirement. Many of the changes are optional; others are mandatory.

Most, but not all, of the changes are effective beginning in 2002. The IRS announced on June 28, 2002 that good faith EGTRRA amendments generally must be made no later than the end of the plan year in which the amendments are required to be, or are optionally, put into effect. This means that most employers will need to (a) make decisions this year about operational changes effective for the 2002 plan year, and (b) adopt formal amendments during the 2002 plan year reflecting optional changes made plus any 2002 required changes.

On a related note, the IRS has decided not to extend the existing deadline for the GUST remedial amendment period. The deadline for individually designed plans to be restated in accordance with legislative and regulatory changes promulgated since 1994 (other than EGTRRA) remains the last day of the 2001 plan year (*i.e.*, December 31, 2001 for calendar year plans).

The remainder of this *Bulletin* provides a brief overview of the principal retirement benefit plan changes made by EGTRRA, followed by a more detailed discussion of those changes. The changes are effective for plan years beginning in 2002 except as otherwise noted.

OVERVIEW

1. **Pre-Tax Contribution Limit Increased**

The employee pre-tax contribution limit for 401(k) and 403 (b) plans will be increased to $11,000 in 2002, and will increase in $1,000 increments during each of the next four subsequent years. After this limit reaches $15,000 in 2006, it will be indexed for inflation in $500 increments.

2. **Contribution Limits Increase at Age 50**

   Higher pre-tax contribution limits will apply to participants who have attained age 50 without regard to other Code limitations. This will enable participants 50 years of age and older to contribute an extra $1,000 in 2002, increasing in annual $1,000 increments to $5,000 in 2006.

3. **Vesting For Matching Contributions Accelerated**

   Employer matching contributions made after the 2001 plan year must be subject to either a three-year cliff or a graduated six-year vesting schedule (*i.e.*, the top-heavy vesting schedules).

4. **Increased Compensation Limit**

   The maximum amount of a participant's compensation that may be considered in a qualified plan has been increased to $200,000.

5. **Increased Section 415 Overall Plan Benefit Limitations**

   The maximum benefit limits under section 415 of the Code have been increased to the lesser of $40,000 or 100% of compensation for defined contribution plans. The section 415 limits also have been increased for defined benefit plans.

6. **Roth Contributions to 401(k) and 403(b) Plans**

   Beginning in 2006, participants can make "Roth" contributions to a 401(k) or 403(b) plan in lieu of pre-tax contributions.

7. **IRA Contributions to Qualified Plans**

   Beginning in 2003, a plan may be set up to permit voluntary IRA contributions, subject to the IRA rules that otherwise apply under the Code.

8. **Multiple-Use Test Repealed For 401(k) Plans**

For 401(k) plans that have matching contributions and/or employee after-tax contributions, the multiple use test is repealed.

9. **Changes to Top-Heavy Rules**

   The top-heavy rules were modified to change the key employee definition, eliminate the need to provide minimum benefit accruals in frozen defined benefit plans, exempt 401(k) safe harbor contribution plans, and permit matching contributions to be used to satisfy the minimum contribution requirements for non-key employees.

10. **Expanded Employer Deduction Limits**

    Employee pre-tax contributions will no longer offset the employer's deduction limit under section 404 of the Code. The maximum contribution limit for employer contributions to profit sharing and stock bonus plans has been increased to 25% of compensation from 15%.

11. **Increase Funding Limits For Defined Benefit Plans**

    The current liability funding limitation for defined benefit pension plans will be repealed, thereby permitting employers to make larger contributions to their pension plans.

12. **Shorter Contribution Suspension For Hardship Withdrawals**

    The length of time that employee pre-tax contributions have to be suspended under the "safe harbor" method when there is a hardship withdrawal from a 401(k) plan has been shortened to six months from 12 months.

13. **Changes to Cash-Out Rules**

    In applying the $5,000 cash-out distribution rule, an employer will be able to disregard rollover contributions made by a participant. If a cash-out distribution is over $1,000, it will have to be transferred to an IRA established by the plan administrator unless the participant elects otherwise, but not until final regulations are issued.

14. **Expanded Rollover Rules**

    The rollover rules have been expanded to permit rollovers between different types of plans, rollovers of after-tax contributions, rollovers from an IRA to a plan and a rollover by a surviving spouse to another plan or an IRA.

15. Simplification of 401(k) Distribution Rules

A 401(k) plan will be able to make distributions to participants who have terminated employment without regard to the "same desk rule."

16. Tax Credit For Employee Retirement Contributions

Certain lower-income participants may be able to claim a tax credit of up to $2,000 for their pre-tax contributions to a 401(k) plan, certain other types of plans or an IRA, in addition to the tax deduction already available for these contributions.

17. Plan Loans for Small Business Owners

Plans will now be able to make loans to participants who are owners of certain unincorporated businesses, partnerships and S-corporations who were previously prohibited from obtaining a loan.

18. S-Corporation ESOPs

Restrictions on ESOP allocations and equity compensation plans will apply to employees with certain ownership interests in S-corporations that sponsor ESOPs.

19. Deduction For ESOP Dividends

A C-corporation will be able to deduct dividends paid to an ESOP even if a participant elects to have the dividends reinvested in stock through the ESOP instead of receiving a payment of the dividends.

20. Expanded Plan Amendment Notice Requirements

Additional notification requirements are imposed on employers before a pension plan amendment that reduces the rate of future accruals (including subsidies) can take effect.

21. Changes to Anti-Cutback Rule

The anti-cutback rule was modified to permit a defined contribution plan to eliminate certain distribution options (other than a lump sum) pursuant to a plan amendment or at the election of a participant in connection with a plan-to-plan transfer. The Act also directs the IRS to issue regulations to liberalize the anti-cutback rule for defined benefit plans.

22. Employer-Provided Retirement Planning Services

Retirement planning services paid by an employer will not be includible in an employee's gross income if the services relate to the employer's plan and are generally available to all employees.

23. Coverage Rules For 401(k) and 403(b) Plans

For tax-exempt employers who maintain 403(b) plans, the minimum coverage rules have been modified so that employees who participate in such plans can be excluded in testing a 401(k) plan maintained by a for-profit affiliate of the tax-exempt employer.

DISCUSSION

1. Pre-Tax Contribution Limit Increased

Current Law: The maximum amount of pre-tax contributions that a participant is able to make to all 401(k) and 403(b) plans is limited to $10,500 for calendar year 2001. Note that this rule applies to all of the plans that a person participates in, including plans maintained by different employers.

Changes Made: Effective for the 2002 calendar year, EGTRRA gradually increases the $10,500 limit to $15,000 over the next five years as follows:

Taxable Year	Increased Limit
2002	$11,000
2003	$12,000
2004	$13,000
2005	$14,000
2006	$15,000

After 2006, the annual limit for pre-tax contributions will be indexed for inflation in $500 increments.

2. Contribution Limits Increase at Age 50

Current Law: The calendar year dollar limitation on pre-tax contributions (currently $10,500) is the same for all employees.

Changes Made: For taxable years beginning in 2002, participants who are at least age 50 (by the end of the year) are permitted to make additional pre-tax contributions to 401(k), 403(b) or 457 plans without regard to the other limitations that apply under the Code. These additional contributions are not subject to discrimination testing as long as all age 50 participants are eligible to make them. The increased contribution amounts are:

Taxable Year	Increased Limit
2002	$1,000
2003	$2,000
2004	$3,000
2005	$4,000
2006	$5,000

After 2006, the increased contribution amount will be indexed for inflation in $500 increments.

3. Vesting for Matching Contributions Accelerated

Current Law: Matching contributions made to a 401(k) plan are subject to the same vesting rules that apply to other employer contributions. Accordingly, the plan must provide that a participant will be fully vested after completing five years of vesting service, or will become vested in annual 20% increments after completing three years of vesting service (and be fully vested after seven years) or be subject to a quicker vesting schedule.

Changes Made: Effective for matching contributions made after December 31, 2001, a plan must provide that the vesting schedule for matching contributions must be at least as favorable as: (a) full vesting after three years of vesting service or (b) vesting in annual 20% increments after completing two years of vesting service (and fully vested after six years).

***Comment*:** An employer is not required to apply this new vesting requirement to other types of employer contributions or to matching contributions made prior to

2002. However, employers also need to consider the administrative complexities of having a plan with more than one vesting schedule.

4. Increased Compensation Limit

Current Law: The maximum amount of a participant's compensation that can be included under a qualified plan currently is limited to $170,000.

Changes Made: For plan years beginning in 2002, EGTRRA increases the maximum amount of a participant's compensation that can be recognized under a plan to $200,000, adjusted for inflation in $5,000 increments.

5. Increased Section 415 Overall Plan Benefit Limitations

Current Law: Section 415(b) of the Code currently provides that the maximum benefit that a defined benefit plan can provide payable at the Social Security retirement age is the lesser of 100% of a participant's high three-year average compensation or $140,000. The dollar limit, adjusted for inflation in $5,000 increments, is increased for participants who retire after their applicable Social Security retirement age. Section 415(c) of the Code currently provides that the maximum amount of contributions and forfeitures that may be allocated to a participant in a defined contribution plan for a plan year may not exceed the lesser of 25% of compensation or $35,000.

Changes Made: EGTRRA made the following changes to the section 415 limitations effective for plan years beginning in 2002: (a) for defined benefit plans, (i) the dollar limit has been increased to $160,000 and (ii) the limitations only have to be decreased for benefits payable before age 62; and (b) for defined contributions plans, (i) the limitation was changed to the lesser of 100% of compensation or $40,000 and (ii) the $40,000 dollar limitation will now be adjusted for inflation in $1,000 increments.

6. Roth Contributions to 401(k) and 403(b) Plans

Current Law: Pre-tax elective deferral contributions made by a Participant to a 401(k) or 403(b) plan are excluded from a participant's gross income in the year they are made. A distribution attributable to these contributions, adjusted for investment gains or losses, is taxable when distributed unless it is rolled over.

Changes Made: Effective for tax years beginning in 2006, a plan may permit a participant to designate his or her contributions as "Roth Contributions" instead of pre-tax elective deferral contributions. Although Roth Contributions will not be excluded from income in the year made, a distribution attributable to Roth Contributions will not be taxable if five years have elapsed since the participant first made a Roth Contribution and the participant has attained age 59-1/2, died or become disabled. Roth Contributions are otherwise treated as pre-tax elective deferral contributions for other purposes of the Code, such as the annual dollar limit applicable to such contributions, the average deferral percentage (ADP) test, full vesting and the other contribution limits imposed under the Code.

Comment: Employers that want to add a Roth Contribution component to their plans will have to adopt plan amendments. Moreover, a separate account will have to be established to account for Roth Contributions and earnings. The IRS is also authorized to impose additional reporting requirements on plan administrators relating to Roth Contributions.

7. IRA Contributions to Qualified Plans

Current Law: Prior to 1987, a participant could make a deductible voluntary contribution to a qualified plan in lieu of contributing to an IRA for a particular year, if permitted under the terms of the plan. Under current law, however, a qualified plan may not permit such contributions.

Changes Made: For plan years beginning in 2003, IRA features may be included under a 401(a) qualified plan, a 403(b) plan or a 457 plan. The corresponding plan provisions must meet the requirements that are applicable to either a traditional IRA or a Roth IRA under the Code. These contributions will not be subject to the limits for employer-sponsored retirement plans under the Code. Although they will be subject to the fiduciary rules of ERISA, they will not be subject to various other requirements of ERISA.

Comment*:* While this change was intended to make retirement savings more convenient for employees, many employers may want to consider the implications of offering IRA contributions features under their plans. In addition to the need to perform separate accounting for such contributions, employers will also have to administer the IRA rules. For example, loans from an IRA to a participant are not permissible under the IRA rules. Moreover, while the fiduciary rules under ERISA will apply, other provisions of ERISA will not apply, such as the civil enforcement provisions of ERISA, which contain a broad preemption of state law. Conceivably, this could mean that an aggrieved participant could bring an action under state law, which generally covers disputes concerning IRAs.

8. Multiple Use Test Repealed For 401(k) Plans

Current Law: For each plan year, a 401(k) plan with matching contributions and/or employee after-tax contributions must perform: (a) the average deferral percentage (ADP) test for employee pre-tax contributions (and certain types of employer matching contributions) and (b) the actual contribution percentage (ACP) test for most employer matching contributions and for employee after-tax contributions. Both tests are performed in the same manner, and are designed to ensure that, as a percentage of compensation, the average contribution made on behalf of the highly compensated employees does not exceed the average for the nonhighly compensated employees by certain limits. Another test, called the multiple use test, applies to prevent a plan from using the more advantageous limits for both the ADP and the ACP tests.

Changes Made: EGTRRA repeals the multiple use test beginning with the 2002 plan year. Plans should be amended to remove provisions incorporating this test.

9. Changes to Top-Heavy Rules

Current Law: A top-heavy plan must provide for minimum contributions and a faster vesting schedule than what is otherwise required by law. In general, a plan is considered to be top-heavy if more than 60% of its assets are attributable to key employees, who include officers earning more than $70,000, 5% owners (based on family attribution rules), 1% owners who earn more than $150,000 and the 10 employees with the largest ownership interest in the employer who earn more than $35,000. In addition, matching contributions cannot be used to satisfy the top-heavy minimum contribution requirement.

Changes Made: Beginning with the 2002 plan year, the following changes apply to the top-heavy rules: (a) a participant who is one of the 10 employees with the largest ownership interest must also earn over $130,000 to be considered a key employee under this criteria, (b) matching contributions will count towards the minimum contribution requirement, (c) a 401(k) plan that is structured to comply with the safe harbor contribution rules that avoid the need to perform the ADP and ACP tests will automatically satisfy the top-heavy rule unless the plan also has a profit sharing contribution feature, (d) a rule requiring that distributions made to key employees over a five-year period be considered in determining whether a plan is top-heavy was changed to one year for distributions other than in-service distributions, and (e) a frozen defined benefit plan that is top-heavy will no longer be required to provide for minimum benefits to non-key employees.

10. Expanded EmployerDeduction Limits

Current Law: The Code imposes an overall maximum deduction limit of 15% of covered compensation for contributions made by an employer to its profit sharing and stock bonus plans for any plan year. In general, if an employer also maintains a money purchase pension plan or a leveraged ESOP, its maximum deduction limit for all of its defined contribution plans is 25% of covered compensation. For purposes of the deduction limitations, employee pre-tax contributions are treated as employer contributions and, therefore, are included in the deduction limitations.

Changes Made: For plan years beginning in 2002, the maximum contribution limit has been increased to 25% of compensation for all defined contribution plans. Accordingly, if an employer maintains only a profit sharing plan, for example, it will be able to contribute up to 25% of compensation to that plan for a year. Moreover, employee pre-tax contributions will no longer count against the employer's deduction limitation.

11. Increased Funding Limits For Defined Benefit Plans

Current Law: Current law provides that an employer may not deduct contributions to a defined benefit plan in excess of 150% of the plan's "current liability" (indexed to 160% for 2002). In general, current liability means all plan liabilities accrued to date minus the lesser of the fair market value of the plan's assets or the value of plan assets determined under a reasonable actuarial method (as defined in the regulations). However, for plans with over 100 participants, employers may elect to contribute up to 100%

of the plan's unfunded current liability (generally the plan's current liability less the value of plan assets determined under a reasonable actuarial method). Plan assets must be valued as of the applicable plan year for which the contribution is being made (or up to one month before the beginning of the plan year). Although there is a 10% excise tax imposed on employers who make nondeductible contributions to a qualified retirement plan, one exception to this tax applies to terminated defined benefit plans with 100 or less participants.

Changes Made: EGTRRA increases the 150% of current liability contribution limit to 165% in 2002 and 170% in 2003. In 2004, the current liability contribution restriction will be repealed, so that an employer will be able to contribute to the plan up to 100% of the plan's projected accrued benefits (the "accrued liability") less the value of the plan's assets. Beginning in 2002, the special rule permitting contributions up to 100% of unfunded current liability will apply to all plans that are covered by the PBGC (plans of professional service employers with less than 25 participants are not covered by the PBGC).

EGTRRA also modifies the 10% excise tax imposed on nondeductible plan contributions by providing that the tax will not apply to a defined benefit plan up to the plan's accrued liability full funding limit. However, in this case, the employer may be restricted from utilizing other exceptions to the excise tax.

Finally, EGTRRA will permit an employer to elect to use a valuation date that is not earlier than one year before the beginning of the applicable plan year if the plan's assets equal 125% or more of its current liabilities.

12. Shorter Contribution Suspension for Hardship Withdrawals

Current Law: Under IRS regulations governing hardship withdrawals from a 401(k) plan, the IRS will not require an employer to verify the actual existence of a participant's financial hardship if certain safe harbor rules are followed. One of these rules requires that the participant be prohibited from making any pre-tax contributions to a 401(k) plan, after-tax contributions to a qualified retirement plan, contributions to a nonqualified plan or contributions to an employee stock purchase plan for 12 months. When the participant is able to resume pre-tax contributions during the next year, the participant's contribution dollar limitation for that year must be reduced by the amount of pre-tax contributions that the participant made in the year of the hardship withdrawal.

Changes Made: EGTRRA changes the 12month contribution suspension period to six months effective for distributions made after December 31, 2001. Plans that utilize the safe harbor hardship withdrawal regulations should be amended to reflect the new rule.

13. Changes to Cash-Out Rules

Current Law: If a participant has a plan balance of $5,000 or less, a plan may provide that he or she does not have the right to defer a distribution to age 65. However, prior to making a mandatory cash-out to the participant, the plan administrator must first provide the participant with information on the participant's right to elect a direct rollover of the distribution (unless the distribution is $200 or less). If the participant does not elect a direct rollover, a mandatory 20% withholding tax rule applies.

Changes Made: EGTRRA makes two important changes to the mandatory cash-out rules. First, effective for distributions made on or after January 1, 2002, in calculating whether a participant's benefit exceeds $5,000, any rollover contributions made by a participant may be excluded. Second, if the amount of the distribution exceeds $1,000, the plan administrator will be required to implement a direct rollover into an IRA established by the plan administrator for the participant unless the participant affirmatively elects a direct rollover to another designated IRA or elects to receive a direct payment. The plan administrator's fiduciary duty for IRA investments will not extend beyond one year and may end earlier if the participant exercises investment control over the IRA. Moreover, the Department of Labor has been instructed to issue safe harbor guidelines for plan administrators in connection with the ERISA fiduciary rules in establishing the IRAs and investing their assets. The new mandatory IRA rollover rule is not effective until the DOL regulations are issued.

14. Expanded Rollover Rules

Current Law: Qualified plan distributions may be rolled over by the participant or a surviving spouse to an IRA. The participant, but not the spouse, has the additional option of rolling over the distribution to another qualified plan that accepts rollovers. A distribution that is first paid to the participant or surviving spouse must be rolled over within 60 days, and the IRS has repeatedly held that it does not have the authority to extend this 60-day rule. Neither after-tax contributions nor a hardship withdrawal of pre-tax elective deferral contributions may be rolled over. Moreover, rollovers of distributions attributable to different types of plans can, in general, only be made to the same type of plan. For example, a distribution from a 403(b) plan cannot be made to a qualified retirement plan.

Changes Made: Effective for distributions made after 2001, EGTRRA has made the following changes to the rollover rules:

a. A surviving spouse will be permitted to roll over a distribution to another plan or an IRA;
b. All hardship withdrawals will be ineligible for rollover treatment;
c. Distributions from a Section 457 plan (sponsored by a governmental or tax-exempt organization) may be rolled over to another plan or an IRA;
d. Rollovers between different types of plans will be permitted. For example, a participant may roll over a distribution from an IRA, 403(b) plan or a 457 plan to a qualified plan;
e. After-tax contributions made to a plan can be rolled over to an IRA or another plan if done through a direct rollover (the receiving plan or IRA must also be able to use separate accounting for the after-tax contributions);
f. The IRS has been provided with the authority to extend the 60-day maximum rollover period due to extraordinary events beyond the control of the taxpayer.

The Special Tax Rules notice utilized by plan administrators must be revised to reflect these new rollover rules.

15. Simplification of 401(k) Distribution Rules

Current Law: A 401(k) plan generally is not permitted to make a distribution of a participant's pre-tax contributions until the participant's attainment of age 59-1/2, the occurrence of a financial hardship, the plan's termination (unless the employer maintains another defined contribution plan other than an ESOP), or the participant's disability, death, or separation from service. The term "separation from service" is a more rigid standard than termination of

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employment, and involves the "same desk rule" concept. Under this concept, if a business unit is sold, for example, and a participant continues to work at the same job but for a different employer, the participant has not incurred a separation from service. Section 401(k) of the Code provides only a limited exception allowing a plan to make distributions to employees affected by the sale of a business under certain circumstances.

Changes Made: EGTRRA simplifies this aspect of the 401 (k) plan distribution rules by replacing the "separation from service" concept with the words "severance from employment." This will allow 401(k) plans to make distributions to participants who are covered by the same desk rule. Since the exception allowing distributions in certain cases involving the sale of a business are no longer necessary, they have been repealed by the Act. This change applies to distributions made after December 31, 2001, even if a participant terminated employment before 2002.

Comment: Many 401(k) plans have provisions relating to the existing distribution rules so that participants who have terminated employment, but are covered under the same desk rule, do not have a right to receive a distribution under the terms of the plan document (thus avoiding a conflict with the plan qualification rule). Accordingly, employers may need to amend their plans to remove these restrictions.

16. Tax Credit For Employee Retirement Contributions

Current Law: Employee pre-tax elective deferral contributions made to a 401(k) or 403(b) plan are excludible from gross income. Taxpayers who are not active participants in a qualified retirement plan or whose income does not exceed certain levels are eligible to make a deductible contribution to an IRA. These contributions reduce a taxpayer's gross income and, therefore, the amount of income subject to taxation. In contrast to a deduction, a tax credit reduces the amount of the actual taxes owed.

Changes Made: For taxpayers with gross income at or below certain specified levels, EGTRRA provides a tax credit for contributions made to these retirement plans beginning in 2002. The tax credit is in addition to the tax deduction already associated with these contributions. Since the credit is nonrefundable, it will not reduce a taxpayer's taxes below $0. The tax credit only applies to the first $2,000 of contributions and is equal to 10%, 20% or 50% based on the taxpayer's income level under the following

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Chicago, Illinois 60601
312/609-7500
Facsimile: 312/609-5005

New York
805 Third Avenue
New York, New York 10022
212/407-7700
Facsimile: 212/407-7799

New Jersey
354 Eisenhower Parkway
Plaza II
Livingston, New Jersey 07039
973/597-1100
Facsimile: 973/597-9607

chart:

Joint Filers	Heads of Households	All Other Filers	Credit Rate
$0-$30,000	$0-$22,500	$0-$15,000	50%
$30,000-$32,500	$22,500-$24,375	$15,000-$16,250	20%
$32,500-$50,000	$24,375-$37,500	$16,250-$25,000	10%
Over $50,000	Over $37,500	Over $25,000	0%

Comment: Although this provision does not directly affect qualified retirement plans, it should encourage lowerpaid employees to make voluntary contributions to qualified plans, such as 401(k) plans.

17. Plan Loans For Small Business Owners

Current Law: A plan loan to a participant is subject to the prohibited transaction rules, but those rules contain an exemption for most participants. However, the exemption does not cover the following groups: (a) sole proprietors, (b) partners who own more than 10% of a partnership's capital or profit interests and (c) S-corporation shareholders who own more than 5% of the stock of the SCorporation. Accordingly, loans to these participants are not exempt from the prohibited transaction rules and are subject to excise taxes.

Changes Made: Effective in 2002, plan loans to these participants will be permitted.

18. S-Corporation ESOPs

Current Law: Effective in 1988, the Internal Revenue Code was amended to provide that an ESOP could be a shareholder in an S-corporation. Although corporate income derived by an S-corporation is generally passed through to its shareholders, an ESOP is tax-exempt and therefore is not taxed on its proportionate share of S-corporation earnings. Accordingly, if an ESOP owns 100% of the stock of an S-corporation, there is no tax liability for the corporation's earnings.

Changes Made: EGTRRA seeks to ensure that S-corporation ESOPs are extended to a broad range of employees. In general, if there is a "prohibited allocation" to a "disqualified individual," then that allocation is treated as a taxable distribution to the individual and a 50% excise tax is imposed on the employer. A participant is a "disqualified individual" if: (i) the deemed ownership interest in the S-corporation by the participant and certain of his or her family members is at least 20% of the outstanding shares in the S-corporation or (ii) for other participants, at least 10% of the shares deemed outstanding in the S-corporation are deemed to be owned by the participant. Note that these tests are performed by (a) including shares allocated in the ESOP, (b) including unallocated shares of stock in the ESOP (by assuming that a portion of these shares are allocated to participants based on the most recent allocation method used by the ESOP), and (c) assuming that synthetic equity shares (as described below) are also outstanding shares of stock.

A 50% excise tax is also imposed on S-corporations that have "synthetic equity" owned by a disqualified person. Synthetic equity means stock options, warrants, restricted stock, deferred issuance stock rights or similar interests that give the person who holds the interest the right to receive or acquire stock of the S-corporation in the future. Synthetic equity also includes stock appreciation rights, phantom stock units or similar rights to receive a cash payment based on the value of the stock.

These new rules apply for plan years beginning on or after January 1, 2005 for ESOPs sponsored by S-corporations that were in existence on or before March 14, 2001. However, for ESOPs established after March 14, 2001 or for ESOP plan sponsors that made an election to be taxed as an S-corporation after March 14, 2001, these new rules apply to plan years ending after March 14, 2001.

19. Deduction For ESOP Dividends

Current Law: Section 404(k) of the Code provides that a C-corporation can deduct dividends paid to an ESOP if either (a) the dividends are used by the ESOP to make payments on an acquisition loan that was used to acquire the shares on which the dividends were paid or (b) the dividends are paid directly to the ESOP participants or paid to the ESOP and then paid to the participants within 90 days.

Change Made: EGTRRA provides that a Ccorporation can also claim a deduction for dividends paid to an ESOP if the participant has the choice of (a) directing that the dividends be reinvested in company stock in the ESOP or (b) having the dividend paid in cash to the participant. This change is effective for taxable years beginning in 2002. EGTRRA also modifies the standard for disallowing an ESOP dividend payment deduction to an "avoidance or evasion of taxation" standard from an "evasion of taxation" standard that may have been harder for the IRS to prove.

Comment: The Securities Exchange Commission ("SEC") has indicated that, if a plan gives a participant a choice between receiving cash and investing in company stock through a plan, then, under the Securities Act of 1933, there has been a sale of a security that must either be registered with the SEC or be exempt from registration. At this point, the SEC has not made its views known on whether this registration requirement also applies to the new ESOP dividend feature. Prior to implementing this new feature in an ESOP, an employer should first consult with counsel on the securities issues under federal and applicable state law.

20. Expanded Plan Amendment Notice Requirements

Current Law: Under Section 204(h) of ERISA, an amendment to a pension plan that has the effect of imposing a significant reduction in the rate of future benefit accruals will not be effective unless affected participants, beneficiaries and employee organizations are provided with advance notice. This rule covers defined benefit pension plans and defined contributions pension plans (*i.e.*, money purchase and target benefit plans). The notice must be provided after the plan amendment is adopted and at least 15 days before it becomes effective.

Changes Made: EGTRRA amends 204(h) of ERISA, and adds a parallel Code section, to expand on this notice requirement and to impose excise taxes if an employer or plan administrator fails to comply with this notice requirement. Under the new notice requirements, which are effective for plan amendments on or after June 7, 2001, the notice also covers amendments that eliminate or provide a significant reduction in early retirement benefits or retirement-type subsidies. The notice must: (a) be provided within a reasonable period of time before the effective date of the plan amendment; (b) be drafted in a manner designed to be understood by the average plan participant; and (c) contain sufficient information to allow participants to understand the effect of the plan amendment.

21. Changes to Anti-Cutback Rule

Current Law: Until recently, an employer was prohibited from amending a plan to eliminate distribution options under the anti-cutback rule. Last year, Treasury regulations were modified so that an employer can amend a defined contribution plan to eliminate distribution options other than a lump sum or certain annuity forms required for a money purchase pension plan. These regulations did not cover defined benefit plans. The anti-cutback rule also protects early retirement subsidies (to the extent accrued) under defined benefit plans.

Changes Made: In general, EGTRRA amends the Code and ERISA to incorporate rules similar to those under the recent Treasury regulations. Moreover, EGTRRA also amends the anti-cutback rule to provide that a plan-to-plan transfer done pursuant to a participant's voluntary election will not violate the anti-cutback rule if the participant could have received a lump sum distribution from the transferor plan even if the transferee plan does not have all of the distribution options contained in the transferor plan. Finally, EGTRRA also directs that regulations be issued to provide that an employer can eliminate optional forms of benefits and early retirement subsidies in a defined benefit plan to the extent that participants are only affected in a "de minimus manner."

22. Employer Provided Retirement Planning Services

Current Law: Many employers provide retirement education or retirement planning services at no cost to their employees. However, the Code does not explicitly exclude the value of such services from an employee's gross income.

Changes Made: EGTRRA amends the Code to provide that an employee's receipt of retirement planning advice and services from an employer will not be treated as income to the employee if the following conditions are satisfied: (a) the services relate to the employer's plan; (b) the services cover the employee or his or her spouse; (c) the services are available to all employees on a substantially equal basis; and (d) the services do not cover such matters as tax preparation, accounting, legal or brokerage services.

23. Coverage Rules For 401(k) and 403(b) Plans

Current Law: Beginning in 1997, employees of tax-exempt organizations were permitted to participate in 401(k) plans. Before 1997, such employees could only make pre-tax contributions to 403(b) tax-deferred annuity plans, which may not be extended to employees of for-profit employers.

Because employees of a tax-exempt employer and employees of a for-profit employer may be treated as being employed by a single employer in certain cases, Treasury regulations provide special guidance in connection with these plans. In general, the regulations provide that the two types of plans may not be combined in performing the minimum coverage test, employees of for-profit employers may be excluded when testing a 403(b) plan and, in testing a 401(k) plan, employees of a not-for-profit employer may only be excluded if more than 95% of all employees could participate in the 401(k) plan.

Changes Made: EGTRRA revises the Treasury regulations by providing that, for purposes of the minimum coverage test, employees of a tax-exempt employer may be excluded if: (a) no such employee is eligible to participate in a 401(k) plan and (b) the 401(k) plan is extended to at least 95% of the employees who are not employed by a tax-exempt employer. This change is effective retroactive to January 1, 1997.

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