

# Economic Growth & Tax Relief Reconciliation Act of 2001

## Introduction

On June 7, 2001, President Bush signed into law the \$1.35 trillion tax cut bill that contained substantial changes in retirement plans, including 403(b) and 457(b) eligible deferred compensation plans. This brief summary highlights the changes.

## Increased Contribution Limits

On January 1, 2002, employee contributions to 403(b) and 457(b) plans will increase and no longer be subject to coordination of contributions to the two types of plans. You may be able to contribute up to the full eligible limits to each of the two types of plans as follows: See table 1.

For 457(b) plans only, the catch-up option for the last three tax years prior to normal retirement age (or actual retirement) will change from \$15,000 to twice the amount of the basic limit. Participants who use the 457 catch-up option will not be eligible to use the age 50 catch-up. This catch-up option does apply to both governmental and non-governmental 457(b) plans.

## Result

Because of the repeal of the coordination of contributions to both types of plans, in 2002, individuals under age 50 can contribute \$11,000 to the 403(b) plan, and \$11,000 to the 457(b) plan. Those over age 50 can contribute \$12,000 to each – with 15 or more years of service, eligible employees over age 50 can contribute as much as \$15,000 to the 403(b) plan.

Table 1

	*BASIC LIMIT	**AGED 50 OR OVER	***403(B) PLANS ONLY 15 YRS. OF SERVICE
2002	\$11,000	\$1,000	Eligible employees may be able to contribute up to \$3,000 more to a maximum of \$15,000
2003	\$12,000	\$2,000	
2004	\$13,000	\$3,000	
2005	\$14,000	\$4,000	
2006 & after, (indexed in \$500 increments)	\$15,000	\$5,000	

\* Applies to both governmental and non-governmental 457(b) plans.

\*\* Applies only to governmental 457(b) plans.

\*\*\* A calculation will be required; subject to prior contributions to elective deferral plans.

## FOR PARTICIPANTS CONTRIBUTING TO BOTH A 457(B) GOVERNMENTAL PLAN AND 403(B) PLAN

The following illustrates the total amounts an employee who contributes to both a 457 plan and a 403(b) plan might be able to contribute beginning in 2002 through 2006 and after (not counting limit increases due to indexing taking place in years after 2006): See table 2.

## 403(b) Calculations Beginning in 2002

Your calculations will be based on 100% of includible compensation (not 25% under IRC 415(c) as is permitted this year) to the above limits for participants making salary reduction contributions only. (For 457(b) plans, the calculations are also based on 100% of includible compensation vs. 33-1/3% for years prior to 2002.) For employer contributions, the dollar limit is changed to \$40,000. The

Table 2

	BASIC LIMITS	AGED 50 & OVER	IF ELIGIBLE: 15 YRS. OF SERVICE; 403(B)	TOTAL
2002	\$22,000	\$24,000	Plus \$3,000	\$27,000
2003	\$24,000	\$28,000	Plus \$3,000	\$31,000
2004	\$26,000	\$32,000	Plus \$3,000	\$35,000
2005	\$28,000	\$36,000	Plus \$3,000	\$39,000
2006 & after	\$30,000	\$40,000	Plus \$3,000	\$43,000

The illustration does not take into consideration the 457 plan catch-up option in the last three tax years before retirement, which would substantially increase the totals (because it is twice the basic dollar limit).

exclusion allowance, and catch-up options A, B and C, have been repealed. A calculation for the 15 or more years of service increased elective deferral limit (as much as \$3,000 per year for employees who are eligi-

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ble) will still be required; however, calculations will be greatly simplified.

### Calculations Beginning in 2001, Immediate Opportunity

For the current year (and retroactively to January 1, 2000), the contributions for years prior to the current one which are being made to state retirement system defined benefit plans (or any other defined benefit plan) will not be subtracted from the exclusion allowance.

### EMPLOYER CONTRIBUTION PLANS Post-Retirement Contributions to 403(b) Plans

Employers will be permitted to make contributions for retired employees for a full five years after the year of retirement up to the maximum limit of 100% of the last full year's includible compensation capped at \$40,000 (beginning after January 1, 2002 and indexed in \$1,000 increments). This provides significant opportunity to replace more expensive severance pay with post-retirement contributions – as well as opportunity to construct early retirement incentive programs. This applies only to 403(b) plans – not to 457 or 401(a) plans.

### Paired 457(b) and 403(b) Plans

Now that the coordination limit does not apply to 457(b) and 403(b) (or 457(b) and 401(k) plans), there will be interest on the part of employers to take advantage of employer contribution plans pairing the two. This would mean that an employer could contribute 100% of the affected employee's compensation up to \$40,000 to the 403(b) plan, while the employee could still make salary reduction contributions (\$11,000/12,000 in 2002 increasing to \$15,000/\$20,000 in 2006 as indicated under the contribution limits section) to the 457 plan. The following chart illustrates the possible amounts that both the employer and the employee might contribute to the paired plans: See table 3.

### Paired 401(a) and 403(b) Plans

While the wording in the bill is not entirely clear, it appears that there are still two separate 415(c) limits for the 401(a) defined contribution plan and the 403(b) plan. The IRS has informally stated that this is the case, and has also said that the reference in the bill to the issue of non-aggregation was a technical correction to the earlier repeal of the 415(e) limits. Most professionals concur with the IRS informal assurance. However, it is important to note that the issue will be closely monitored for guidance that would impact the current position. Some do believe that we could get Technical Corrections (once more) to force aggregation of the two limits.

### PENSION PORTABILITY

401(a), 403(b), Governmental 457(b), SEP, and IRA assets can be interchangeably rolled over, provided that participants are eligible for a distribution, and provided that the distribution is an eligible rollover distribution. (Pension portability does not extend to Roth IRAs nor to non-governmental 457(b) plans.) The following points are important:

1. Governmental 457(b) assets have not been eligible for rollover treatment in the past – thus, there will be enormous interest in the new ability to take advantage of tax-deferral. It is important to note that qualified plan assets, 403(b) values, or

deductible IRA values that are rolled into a 457(b) plan will be required to be separately tracked because the additional 10% federal income tax penalty will continue to be applied to the assets rolled into the 457(b) plan. It is possible that 457(b) plans will not accept the rollovers from other types of plans because of the requirement. If 457(b) plan assets are rolled into qualified plans, 403(b) plans, or IRAs, there is no requirement that values be segregated because the 457(b) assets will be subject to the 10% premature distribution penalty after the rollover (if applicable). (Keep in mind that 457(b) distributions are not subject to the additional 10% federal income tax penalty.)

2. Conduit IRAs will no longer be relevant. This will mean that any IRA consisting of pre-tax account values (whether derived from annual contribution IRAs, or rollovers from other types of pre-tax plans) can be rolled to (for example) the 403(b) contract. Because IRAs have no withdrawal restrictions, many IRA account holders may be interested in combining those accounts with their “workplace plan.” As long as the “once per year IRA rollover rule” is not violated, those accounts will be available for immediate rollover. Also, IRAs consisting of after-tax contributions (often referred to as nondeductible IRAs) are not permitted to be rolled over to any type of “workplace plan,” only to another IRA.

Table 3

	EMPLOYER/ 403(B) PLAN	EMPLOYEE/ 457 PLAN:		
		BASIC	*AGED 50 & OVER	LAST 3 YEARS
2002	\$40,000	\$11,000	\$12,000	\$22,000
2003	\$40,000	\$12,000	\$14,000	\$24,000
2004	\$40,000	\$13,000	\$16,000	\$26,000
2005	\$40,000	\$14,000	\$18,000	\$28,000
2006 & after	\$40,000	\$15,000	\$20,000	\$30,000

\*457(b) Governmental Plans Only

Note: The \$40,000 limit is indexed in \$1,000 increments instead of \$5,000 increments as has been the case for years prior to 2002. Thus, it is probable that limits will move up frequently, subject to increases in the CPI, the index used.



3. Other than the 10% premature distribution penalty tax issue for 457 governmental plan assets rolled over, the rolled over amounts will assume the characteristics of the type of account/plan to which it is rolled.

### **USE OF 403(B) OR 457 ASSETS TO PURCHASE YEARS OF SERVICE CREDITS**

In many states, participants in the state retirement system defined benefit plans are given an option to purchase additional years of service in that plan – to increase credits for larger monthly income. Generally, participants have made additional pre-tax contributions directly from their paychecks to purchase those credits. On January 1, 2002, tax-free transfers of 403(b) and 457 plan assets will be permitted to purchase the additional years of service credits. If values are transferred to purchase defined benefit income, then contributions can be increased (for those not already contribution at maximum levels) to replace the values transferred.

### **OTHER CHANGES Contributions to an IRA or a Roth IRA**

Limits in 2002 will increase to \$3,000, plus \$500 additional for participants age 50 or older, and will grade up to \$5,000 in 2008. Those age 50 or older will be able to contribute an additional \$1,000 per year in 2006 and after. Indexing in \$500 increments will apply after 2008. The eligibility rules for IRAs and Roth IRAs have not changed.

### **The Roth 403(b) or 401(k)**

After-tax contributions will be permitted, with distribution rules similar to the Roth IRA – however, the effective date is delayed to January 1, 2006.

### **NEW CHANGES SCHEDULED TO EXPIRE**

The bill contains a sunset provision which would cause all of the changes to expire on December 31, 2010 and the “old rules” to apply after that. The provision was

added to avoid filibuster (which could have seriously impacted passage). A new bill, H.R. 2316, has already been introduced to eliminate the sunset provision in EGTRRA; however, we don't know at this time whether or not this Congress will deal with it. It may be up to future Congresses to change the sunset provision to make the changes permanent.



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