

## The "Taxpayer Relief Act of 1997" Brings More Changes to Qualified Plans and IRAs

**WHO'S AFFECTED** The new law affects sponsors of qualified defined benefit and defined contribution plans, including governmental plans and church plans, as well as sponsors of tax-sheltered annuity plans and holders of individual retirement accounts and annuities.

**BACKGROUND AND SUMMARY** On August 5, 1997, President Clinton signed into law the Taxpayer Relief Act of 1997 (TRA'97). This new law includes both revenue-raising provisions and pension simplification provisions, including clarification of several provisions that were just enacted last year in the Small Business Job Protection Act of 1996 (SBJPA). Major changes include an increase in the first level tax on prohibited transactions, increases to the current liability full funding limit for defined benefit plans, an increase to the "small benefits" cashout threshold, and the elimination of the requirement to file copies of employee booklets with the Department of Labor. In addition, special provisions are aimed at plans sponsored by state and local governments, church plans and employee stock ownership plans (ESOPs).

TRA'97 also makes major changes to the availability of deductible individual retirement arrangements (IRAs) and creates two new types of nondeductible IRAs: the Roth IRA and the Education IRA.

**ACTION AND NEXT STEPS** Most provisions in TRA'97 are effective for years beginning after December 31, 1997. Qualified plans and tax-sheltered annuity plans do not have to be amended to reflect these changes until the 1999 plan year. Plans sponsored by state and local governments do not have to be amended until the 2001 plan year.

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\*Republished December 2004 to reflect Prudential Financial's acquisition of CIGNA's retirement business.

## **The "Taxpayer Relief Act of 1997" Brings More Changes to Qualified Plans and IRAs**

The qualified plan changes made by the Taxpayer Relief Act of 1997 (TRA'97) may generally be classified as pension simplification items, revenue-raising provisions, and miscellaneous changes affecting governmental plans, church plans, and employee stock ownership plans (ESOPs). In addition, TRA'97 greatly increases the attractiveness of individual retirement arrangements (IRAs) and creates two new types of nondeductible IRAs.

### **"Pension" Simplification**

- **Partners May Receive True Matching Contributions**

Matching contributions made to partners will no longer be treated as 401(k) elective contributions, subject to the annual limit on deferrals, the actual deferral percentage (ADP) test, and special rules on the vesting and distribution of 401(k) deferral contributions. Instead, they are treated like matching contributions made to any other employee and are subject to the actual contribution percentage (ACP) test.

This provision is generally effective for plan years beginning after December 31, 1997. However, it applies to SIMPLE Plans for plan years beginning after December 31, 1996.

- **Rollover Contributions Will Not Disqualify a Plan**

TRA'97 requires the IRS to provide clarification that a plan making a direct rollover distribution does not have to have a determination letter in order for the receiving plan administrator to reasonably conclude that the contribution is a valid rollover.

- **Elimination of Filing Requirements**

Effective August 5, 1997, plan sponsors no longer have to file summary plan descriptions (SPDs, also called employee booklets) and summaries of material modifications (SMMs) automatically with the Department of Labor (DOL). While they must still be supplied to plan participants and beneficiaries within specific time periods, plan sponsors now only have to provide copies to the DOL upon request. A maximum civil penalty of \$1,000 per request may be imposed for failure to supply these documents upon request from the DOL.

- **Tax Sheltered Annuity Plan Limit Revised**

TRA'97 makes two changes to the contribution limits that apply to tax-sheltered annuity plans. Effective for years beginning after December 31, 1997, the includible compensation on which a participant's maximum exclusion allowance is based will be a participant's gross compensation. That is, it will be compensation including elective deferral contributions made to 401(k) plans, tax-sheltered annuity plans and cafeteria plans.

TRA'97 also directs the IRS to issue regulations revising the exclusion allowance rules to reflect the elimination of the standard combined plan benefit limit effective for limitation years beginning after December 31, 1999.

- **Paperless Plan Administration**

TRA'97 instructs both the DOL and the IRS to provide plan sponsors with guidance for providing required notices and obtaining required consents using new technology. This guidance is to be designed to:

- Interpret the notice, election, consent, disclosure and time requirements, and related recordkeeping requirements, as applied to the use of new technologies while continuing to protect the rights of participants and beneficiaries; and
- Clarify the extent to which writing requirements under the Internal Revenue Code may permit paperless transactions.

This deadline for providing this guidance is December 31, 1998.

- **Nondeductible Plan Contributions**

Effective for tax years beginning after December 31, 1997, contributions made to defined contribution plans that are not deductible because they exceed the combined plan deduction limit are not subject to the 10% excise tax on nondeductible contributions to the extent they do not exceed the amount of the employees' 401(k) elective deferral contributions plus the employer's matching contributions.

- **Offset of Plan Benefits**

TRA'97 creates an important new exception to ERISA's nonassignment and anti-alienation rule. This new exception permits a qualified plan to reduce a participant's plan benefits in the event:

- The participant is convicted of committing a crime involving the plan;
- A court enters a civil judgement (or consent order or decree) against the participant with respect to a violation of the ERISA's fiduciary requirements; or
- A settlement agreement is reached between the Secretary of Labor or the Pension Benefit Guaranty Corporation and the participant in connection with a violation of ERISA's fiduciary rules.

The order establishing the participant's liability must require the offset of the plan's benefit to offset the liability and the participant's spouse must consent to the offset unless she is also a party to the judgement, unless the settlement provides a 50% survivor annuity to the spouse.

This new rule is effective for judgements, orders and decrees issued and settlement agreements entered into on or after August 5, 1997.

- **Plan Amendment Adoption Deadline**

In general, TRA'97 plan or contract amendments are not required until the first day of the first plan year beginning after December 31, 1998. Amendments to state and local government plans are not required until the first day of the first plan year beginning after December 31, 2000.

If a plan amendment is made before the amendment due date and prior to that amendment, the plan is operated in accordance with the terms of that amendment, the plan will not violate the anticutback rules as the result of applying that amendment.

## **Revenue-Raising Provisions**

- **"Small Benefits" Cashout Threshold Increased**

The threshold for making plan distributions without needing participant or, if applicable, spousal consent has been raised from \$3,500 to \$5,000, effective for plan years beginning

after August 5, 1997. Like the old threshold amount, the new amount is not indexed for inflation.

- "Success Taxes" Eliminated

TRA'97 has repealed the "success taxes." The success taxes are two excise taxes imposed on taxpayers who the government feels are too successful in saving for retirement.

SBJPA suspended the application of the 15% excise tax on "excess distributions" (for 1997: annual distributions exceeding \$160,000 or single sum distributions exceeding \$800,000) from qualified plans, tax sheltered annuity plans and IRAs for distributions received in 1997, 1998 and 1999. TRA'97 has eliminated this tax altogether for distributions received after December 31, 1996.

In addition, TRA'97 has eliminated the 15% estate tax on excess retirement accumulations. This tax applied to the balance in any retirement plan that exceeded the present value of a benefit that would not have been subject to the 15% excise tax on excess distributions. This tax repeal applies to participants dying after December 31, 1996.

- Tax on Prohibited Transactions Increased

Effective for prohibited transaction occurring after August 5, 1997, the first level tax on prohibited transactions is increased from 10% to 15%. The second level tax, which applies if the transaction is not corrected within a specified time period, remains at 100% of the transaction amount.

- Basis Recovery Rules Modified Again

SBJPA revised the method for determining the amount of an annuity that was not subject to an income tax because it represented a return of the individual's investment in the annuity ("basis"). TRA'97 further modifies these basis recovery rules by providing a new table to be used to determine the basis recovery for benefits based on the life of more than one annuitant. This new table must be used for benefits that first become payable after December 31, 1997.

### **Additional Changes**

- Full Funding Limit is Increased

The full funding limit for a defined benefit plan is the lesser of the plan's accrued liability or 150% of its current liability. For plan years beginning after December 31, 1998, the 150% full funding limit is increased as follows:

<b>Plan Year Beginning</b>	<b>Limit</b>
1999 and 2000	155%
2001 and 2002	160%
2003 and 2004	165%
2005 and later	170%

Amounts that cannot be contributed due to the current liability full funding limit must be amortized over 20 years. However, any amortization base remaining at the end of the 1998 plan year must be amortized over a period equal to 20 years less the number of years since the base was established.

- **New Limits Applied to 401(k) Plan Investments**

For plan years beginning after December 31, 1998, an employer stock investment limit applies to 401(k) plans that require elective deferrals equal to more than 1% of an employee's compensation to be invested in employer stock or employer real property. In these situations, the total amount of 401(k) elective deferrals that can be invested in employer stock is limited to 10% of the plan's total assets. However, this limit does not apply:

- If the value of the assets of all of the employer's profit sharing and stock bonus plans does not exceed 10% of the values of the assets of all the employer's pension plans.
- To employee stock ownership plans (ESOPs).

This new limit applies to elective deferrals for plan years beginning after December 31, 1998 and earnings on those deferrals. However, pre-1999 earnings on deferrals are not counted toward the limit.

### **State and Local Government Plans**

- **401(k) Plans Available to Certain Entities**

SBJPA made 401(k) plans available again to tax-exempt organizations. However, state and local governments were still prohibited from offering 401(k) plans, unless they had been in existence before May 6, 1986. Effective for years beginning after December 31, 1997, TRA'97 permits mutual irrigation or ditch companies and state or municipal water districts to maintain 401(k) plans, even if the company or district is considered to be a state or local government organization.

- **Nondiscrimination Rules Do Not Apply**

Since the enactment of the Tax Reform Act of 1986 (TRA'86), the IRS has continued to delay the effective date for applying new and revised nondiscrimination rules to plans sponsored by state and local governments. Effective for plan years beginning on or after August 5, 1997, state and local government plans are exempt by law from the following nondiscrimination and minimum participation rules:

- The minimum participation requirement, applicable only to defined benefit plans since the enactment of SBJPA.
- The minimum coverage requirement.
- The requirement that a qualified plan not provide benefits or contributions in amounts that discriminate in favor of highly compensated employees (the "nondiscrimination in amounts" requirement).
- The requirement that a plan's benefits, rights and features be available on a nondiscriminatory basis.
- The actual deferral percentage (ADP) test applicable to 401(k) plans.

- The actual contribution percentage (ACP) test applicable to plans that contain post-tax employee contributions or employer matching contributions.
- The nondiscrimination rules applicable to tax-sheltered annuity plans.
- Special Limits Apply to Additional Purchased Service Credits

Many defined benefit plans sponsored by state or local governments let participants purchase additional service credits. Under TRA'97, these purchases may be counted toward either the defined contribution annual additions limit for the year of purchase or as part of the participant's overall accrued benefit subject to the defined benefit plan limit on accruals. During any year, one participant may have his additional service credits applied toward the defined benefit plan limit, while another participant has his credits applied toward the annual additions limit.

These special rules do not apply to:

- The repayment upon rehire of distributions received at the time of an earlier termination of employment.
- Make up contributions made under the veterans reemployment rights law.
- "Pick up" contributions.

These rules apply to contributions made after December 31, 1997 to purchase additional service credits. A special transition rule applies to plans that permitted such purchases before January 1, 1997.

- Defined Benefit Dollar Limit Does Not Apply to Police and Firefighters

In general, defined benefit plan benefits are limited to the lesser of 100% of the participant's average compensation or (for 1997) \$125,000. The compensation limit does not apply to governmental plans. Effective for years beginning after December 31, 1996, the dollar limit is not reduced for police or fire department employees who take early retirement. However, it is increased when benefits begin after age 65.

### **Church Plans**

- Contributions for Self-Employed Ministers

Effective for years beginning after December 31, 1997, contributions made to church plans for self-employed ministers are not included in the ministers' income if those contributions would have been tax-exempt if the minister had been a church employee.

- Ministers Excluded from Nondiscrimination Testing

Effective for years beginning after December 31, 1997, a minister who is employed by an organization other than a church, which does not participate in the church plan being tested, does not have to be counted as a church employee for purposes of nondiscrimination testing.

### **Employee Stock Ownership Plans (ESOPs)**

- ESOPs of S Corporations May Distribute Cash

Effective for tax years beginning after December 31, 1997, ESOPs sponsored by S corporations may distribute cash to plan participants as long as the employees have a right

to require the employer to purchase employer securities and will not violate ERISA's prohibited transaction rules in doing so.

- **Unrelated Business Income Tax Does Not Apply to S Corporation ESOPs**

Effective for tax years beginning after December 31, 1997, S corporation income or loss items will not flow through to ESOPs sponsored by those corporations. Therefore these ESOPs will not be subject to unrelated business income tax (UBIT) on those items.

### **Individual Retirement Arrangements (IRAs)**

- **Increased Eligibility for Deductible IRAs**

Effective for tax years beginning after December 31, 1997, an individual will not be considered to be an active participant in an employer-sponsored retirement plan merely because his or her spouse is such an active participant. This new provision will make deductible IRAs available to more individuals.

In addition, the phaseout income range for deductible IRAs is raised. The \$2,000 deduction limit will now be phased out as follows:

<b>Single Taxpayers</b>	
<b>Tax Year</b>	<b>AGI Phase-Out Range</b>
1998	\$30,000 — \$40,000
1999	\$31,000 — \$41,000
2000	\$32,000 — \$42,000
2001	\$33,000 — \$43,000
2002	\$34,000 — \$44,000
2003	\$40,000 — \$50,000
2004	\$45,000 — \$55,000
2005 and later	\$50,000 — \$60,000

Joint Returns	
Tax Year	AGI Phase-Out Range
1998	\$50,000 — \$60,000
1999	\$51,000 — \$61,000
2000	\$52,000 — \$62,000
2001	\$53,000 — \$63,000
2002	\$54,000 — \$64,000
2003	\$60,000 — \$70,000
2004	\$65,000 — \$75,000
2005	\$70,000 — \$80,000
2006	\$75,000 — \$85,000
2007 and later	\$80,000 — \$100,000

- The Roth IRA

Effective for tax years beginning after December 31, 1997, individuals may make annual nondeductible contributions of as much as \$2,000 to new Roth IRAs. However, the \$2,000 limit is phased out for individual taxpayers with AGI between \$95,000 and \$110,000 and married taxpayers filing jointly with AGI between \$150,000 and \$160,000.

Distributions from Roth IRAs are not taxable if they are made at least five years after the first contribution was made to a Roth IRA and

- On or after the IRA holder reaches age 59½;
- To a beneficiary after the death of the IRA holder;
- To the IRA holder on account of his disability; or
- For first-time home buyer expenses.

In addition, Roth IRAs are not subject to the minimum required distribution rules or incidental death benefit rules applicable to other IRAs. In fact, taxpayers who have reached age 70½ may continue to contribute to Roth IRAs.

Taxpayers with AGI of less than \$100,000 may rollover or convert an existing IRA to a Roth IRA before January 1, 1999, subject to certain rules for including the transferred amounts in income.

In addition, old-style nondeductible IRAs are still available. However, the maximum amount any individual can contribute to all his IRAs (deductible and nondeductible) in one tax year is \$2,000.

- **Additional Exception to 10% Excise Tax on IRA Distributions**  
Effective for tax years beginning after December 31, 1997, the 10% additional tax on early distributions will not apply to amounts withdrawn from any IRA (deductible, nondeductible and Roth IRAs) to pay first-time home buyer expenses.
- **Penalty-Free IRA Distributions to Pay Educational Expenses**  
After December 31, 1997, an individual may take penalty-free distributions from all types of IRAs to pay higher education expenses for himself, his spouse, or either one's child or grandchild for academic periods beginning after December 31, 1997. Qualifying expenses include tuition, fees, books, supplies, required equipment, room and board and graduate expenses. The amount of these expenses that may be paid with IRA distributions is reduced by tax-free scholarships and other tax-free assistance that the student receives.
- **The Education IRA**  
In addition to taking penalty-free distributions from regular IRAs to pay educational expenses, beginning January 1, 1998, taxpayers may establish Education IRAs for each child under age 18. Annual nondeductible contributions of as much as \$500 may be made for each eligible child. Like the Roth IRA contribution limit, this \$500 limit is phased out for individual taxpayers with AGI between \$95,000 and \$110,000 and for married taxpayers filing joint returns with AGI between \$150,000 and \$160,000.  
Distributions from these accounts are tax free if they do not exceed the amounts spent on the following qualified education expenses: post-secondary tuition, fees, books, supplies, equipment and basic room and board expenses.  
Any amounts remaining in the IRA after all qualifying expenses have been paid must be distributed when the beneficiary reaches age 30. At that time, the earnings will be subject to tax and penalty. However, before the beneficiary reaches age 30, the remaining balance may be rolled over or transferred tax-free to another Education IRA for a family member of the beneficiary.
- **IRA Investments**  
Effective for tax years beginning after December 31, 1997, IRA assets may be invested in certain platinum coins and gold, silver, platinum or palladium bullion.

## **Effective Dates Summary of Qualified Plan Provisions Of the "Taxpayer Relief Act of 1997"**

### **Changes Effective in 1997**

- Partners May Receive True Matching Contributions in SIMPLE Plans
- Elimination of SPD and SMM Filing Requirements
- Plan Benefits May Be Offset to Repay Amounts Owed to the Plan
- Threshold for "Small Benefits" Cashouts Increased
- 15% Excise Tax on Excess Distributions Repealed
- 15% Estate Tax on Excess Retirement Accumulations Repealed

- First Level Tax on Prohibited Transactions Increased to 15%
- Nondiscrimination Rules Do Not Apply to State and Local Government Plans
- Defined Benefit Dollar Limit is Not Reduced for Early Retirement of Police or Firefighters

#### **Changes Effective in 1998**

- Partners May Receive True Matching Contributions in Non-SIMPLE Plans
- DOL and IRS to Provide Guidance on Paperless Plan Administration
- DC Plan Contribution Deduction Limit Revised
- Basis Recovery Rules Modified
- 401(k) Plans Available to Certain Governmental Entities
- Special Limits Apply to Additional Service Credits Purchased by Participants in Governmental Plans
- Contributions May Be Made to Church Plans for Self-Employed Ministers
- Certain Ministers are Excluded from Church Plan Nondiscrimination Testing
- ESOPs of S Corporations May Distribute Cash
- Unrelated Business Income Tax Does Not Apply to S Corporation ESOPs

#### **Changes Effective in 1999**

- TRA'97 Plan Amendments Must Be Made to Non-Governmental Plans
- Defined Benefit Plan Full Funding Limit is Increased
- 401(k) Plan Investments in Employer Stock Limited to 10% of Plan Assets

#### **Changes Effective in 2000**

- Tax-Sheltered Annuity Plan Limit Aligned With General Plan Limits

#### **Changes Effective in 2001**

- TRA'97 Plan Amendments Must Be Made to State and Local Government Plans

### **Effective Dates Summary of IRA Provisions of the "Taxpayer Relief Act of 1997"**

#### **Changes Effective in 1998**

- Active Participant Definition Changed for Purposes of Establishing a Deductible IRA
- Phase-Out Income Ranges for Deductible IRAs Increased
- Nondeductible Roth IRAs Available
- IRA Withdrawals to Pay First-Time Home Buyer Expense Not Subject to 10% Early Distribution Excise Tax

- IRAs May Make Penalty-Free Distributions to Pay Educational Expenses
- Nondeductible Education IRAs Available
- IRA Assets May Be Invested in Certain Coins and Bullion

**Pension Analyst by Prudential Retirement**

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Editor: Mitzi Romano (860) 534-2768