

Highlights of the 2001 Tax Act

Sunset Provision. In order to comply with the Congressional Budget Act of 1974, the Economic Growth and Tax Relief Reconciliation Act of 2001 provides that all provisions of, and amendments made by, the 2001 Act shall not apply to taxable, plan, or limitation years beginning after 2010. The Internal Revenue Code (IRC) and ERISA will thereafter be applied and administered as if these provisions and amendments had not been enacted.

INDIVIDUALS

Tax-Rate Reductions. Reductions in individual income tax rates will be phased in over a six-year period beginning in 2001. A new 10% rate applies to the first \$6,000 of single individuals' taxable income, the first \$10,000 of taxable income for heads of households, and the first \$12,000 of joint filers' taxable income. In 2001, most taxpayers will receive the benefit of the 10% rate through a rate reduction credit. Following completion of the rate reductions, there will be six tax brackets: a 10% bracket, a 15% bracket, a 25% bracket, a 28% bracket, a 33% bracket, and a 35% bracket. The new 10% rate is limited to individuals, but the other reductions also apply to estates and trusts.

Repeal of itemized deduction phase-out. For post-2009 tax years, the limitation on itemized deductions for higher-income taxpayers, under which itemized deductions are reduced when adjusted gross income (AGI) exceeds certain threshold amounts, will be repealed. The repeal will be phased in over a five-year period beginning in 2006.

Repeal of personal exemption phase-out. The personal exemption phase-out for higher-income taxpayers will be eliminated for post-2009 tax years. The repeal will be phased in over a five-year period beginning in 2006.

Marriage-Penalty Relief. The standard deduction for married taxpayers filing jointly will be increased, over a five-year period beginning in 2005, to twice the amount applicable to single taxpayers.

15% tax-rate bracket. The marriage penalty will be reduced by gradually increasing the size of the 15% tax-rate bracket for joint filers until it reaches twice the size of the 15% bracket applicable to single taxpayers. The increase will be phased in over four years, beginning in 2005.

Tax Credits. For married taxpayers filing jointly, the earned income credit (EIC) phase-out point will be gradually increased \$3,000 (\$1,000 in 2002); this amount will be adjusted for inflation after 2008. For EIC purposes, the definition of "earned income" will not include nontaxable employee compensation; the credit will not be reduced by the amount of an individual's alternative minimum tax liability; and the EIC will be calculated based on the individual's adjusted gross income (AGI), rather than modified AGI. Also, the relationship test was broadened and the tie-breaking rule was modified.

Child tax credit. The \$500-per-child tax credit will gradually be doubled, reaching \$1,000 in 2010 (\$600 in 2001-2004). Taxpayers can claim the credit against the alternative minimum tax (AMT) on a permanent basis. Also, the credit will be refundable to the extent of 10% of earned income in excess of \$10,000 for tax years 2001-2004 (15% after 2004). Child tax credit payments will not be includible in income for purposes of determining eligibility for benefits under federal means-tested programs.

Dependent care credit. The maximum dependent care credit, the amount of qualifying employment-related expenses for which credits may be claimed, and the income threshold for phase-out of the credit will increase in 2003.

Adoption tax credit. The credit for special needs and nonspecial needs adoptions has been made permanent and will increase to \$10,000 per eligible child in 2002. Also, employees will be able to exclude from gross income up to \$10,000 in adoption assistance benefits received from an employer. The credit and the exclusion will both be adjusted for inflation. The starting point of the income phase-out range for the credit and the exclusion will increase from \$75,000 to \$150,000 of modified AGI.

Individual Retirement Accounts (IRAs). The maximum amount of tax-favored contributions to IRAs and Roth IRAs will gradually increase from the current \$2,000 limit to \$5,000 in 2008 (\$3,000 in 2002-2004), and will then be adjusted for inflation. Individuals who have attained age 50 will be permitted to make additional "catch-up contributions" to their IRAs.

Deemed IRAs. Beginning in 2003, if an employer plan allows employees to make contributions to separate accounts that meet the requirements for IRAs or annuities, the accounts will be deemed individual retirement plans, rather than qualified plans, for all IRC purposes.

Alternative Minimum Tax (AMT). The AMT exemption amounts will increase for tax years 2001 through 2004 by \$4,000 for joint filers and surviving spouses, and by \$2,000 for other individual taxpayers (the increase does not apply to estates and trusts).

Exclusions from Income. Beginning in 2002, the value of qualified retirement planning services provided to employees or their spouses by an employer that sponsors a qualified retirement plan will be excludable from income, subject to a nondiscrimination rule.

Victims of Nazi persecution. Restitution received after 1999 by victims of Nazi persecution or their heirs is excludable from gross income.

Disaster areas. After June 6, 2001, certain tax-related deadlines may be postponed by the IRS up to 120 days for taxpayers affected by a presidentially declared disaster.

ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX

Repeal of Estate and Generation-Skipping Transfer (GST) Taxes. The estate and generation-skipping transfer (GST) taxes are repealed with respect to decedents dying and transfers occurring after 2009. Beginning in 2002, the 5% surtax on estates will be eliminated, increases in exclusions from the estate tax will be phased in, and the maximum estate and GST tax rates will be gradually reduced.

Rates, Exemptions and Deductions During Phaseout. Although the gift tax will be retained following the repeal of the estate and GST taxes, phased-in reductions in the maximum tax rate will begin in 2002 and continue until the top marginal gift tax rate falls to 35% in 2010. The gift tax exclusion will increase to \$1 million for gifts made after 2001.

Family-owned business deduction. The estate tax exclusion for qualified family-owned business interests (QFOBIs) will be repealed for estates of decedents dying after 2003.

State death taxes. The credit for state inheritance taxes will be gradually reduced beginning in 2002 and repealed completely for the estates of decedents dying after 2004; at that point, it will be replaced by a deduction.

Basis Rules, Reporting, and Related Requirements. The step-up in basis at death is eliminated for heirs of decedents dying after 2009. Beginning in 2010, an heir's basis in inherited property will be equal to the lesser of the decedent's adjusted basis or the property's fair market value (FMV) at the time of the decedent's death. An executor may elect to increase the bases of a portion of the decedent's assets to a

stepped-up, date of death value. If an executor satisfies a pecuniary bequest with appreciated property, the estate will recognize gain only to the extent that the property's FMV at the time of the transfer exceeds its FMV at the time of the decedent's death.

Reporting requirements and penalties. Executors of estates of decedents dying after 2009 must file information returns with the IRS reporting large transfers from the estate and the disposition of appreciated property that the decedent acquired by gift or other lifetime transfer for less than adequate consideration during the three-year period ending on the date of death. Executors must also furnish information statements to recipients of the gifted property. A \$10,000 penalty will be imposed for failure to file required returns with the IRS; a \$500 penalty will be imposed for each failure to furnish a statement to a property recipient; and a \$50 penalty will be imposed for each failure to furnish a statement to a beneficiary.

Gain on sale of decedent's principal residence. The income tax exclusion of gain from the sale of a principal residence will extend to a decedent's principal residence that is sold by the estate, an heir, or a qualified revocable trust of a decedent dying after 2009.

Rules for Generation-Skipping Trusts. In circumstances involving lifetime "indirect skips," the unused portion of an individual's GST tax exemption will be allocated to the property transferred to the extent necessary to make the inclusion ratio for the transferred property equal to zero. Trusts that are split in a "qualified severance" will be treated as separate trusts for purposes of the GST tax. The dates on which allocations of the GST tax exemption become final are clarified, and relief is provided for transferors who inadvertently fail to allocate the GST tax exemption on timely gift tax returns.

Installment Payment Provisions. For estates of decedents dying after 2001, for purposes of installment payments of estate taxes attributable to a closely held business interest, the definition of "closely held business" will be expanded to include entities with up to 45 partners or shareholders. Also, the requirement that stock be non-readily tradable in order to qualify for installment payments will apply only to the stock of holding companies, not to the stock of operating subsidiaries.

EDUCATION INCENTIVES

Exclusions from Income. The exclusion for employer-provided educational assistance will be extended to graduate-level education and made permanent, effective for courses beginning after 2001.

Qualified state tuition programs. For post-2001 tax years, the definition of a "qualified tuition program" (QTP), which was previously limited to state-run programs, will be expanded to include certain prepaid tuition programs that are established and maintained by eligible private educational institutions. State-run QTP distributions will be excludable from gross income to the extent that they are used to pay for qualified higher education expenses; the exclusion will expand to QTPs established and maintained by non-state entities for distributions made in post-2003 tax years. Rules have been provided that coordinate the claim for Code Sec. 25A education credits with distributions received from an education IRA and QTP in the same tax year. Rollovers among different programs will not constitute distributions, the definition of family members has been expanded, dollar amount limitations on room and board distributions were removed, and enrollment and attendance expenses of special needs students will constitute qualified higher education expenses.

National Health Service Corps (NHSC) and Armed Forces scholarships. Amounts received by degree candidates at qualified educational organizations from the NHSC or the Armed Forces Scholarship Program for tuition and other expenses related to the students' course of instruction after 2001 will be excludable from income, even though a future service obligation is connected to the scholarships.

Education IRAs. The limit on maximum annual contributions to an education IRA increases from \$500 to \$2,000 after 2001, and income phase-outs for married contributors increase to twice the amounts applicable

to single taxpayers. The category of expenses that can be paid with tax-free earnings from education IRAs is expanded to include elementary and secondary education costs, whether incurred in public, private, or religious schools. Contributions may be made for special needs children over age 18, and continuation of accounts is permitted for special needs beneficiaries over age 30. Also, entities may contribute to accounts, contributions may be made until the return due date, the time for returning excess contributions has been extended, and coordination rules are provided for education credits and qualified tuition programs.

Deductions. The modified AGI phase-out ranges for eligibility for the student loan interest deduction will be increased for tax years ending after 2001 and adjusted annually for inflation after 2002.

Higher education expenses. From 2002 through 2005, a new above-the-line deduction can be claimed for qualified tuition and related expenses incurred by taxpayers whose AGI does not exceed specified levels.

Tax-Exempt Bonds. The additional amount of governmental bonds for public schools that can be issued by small governmental units without subjecting them to the arbitrage rebate requirement will be increased for calendar years after 2001.

BUSINESS

Corporate Estimated Tax. A short deferral period has been provided for all or a part of the required corporate quarterly estimated tax payments due in September 2001 and 2004.

Alaska Native Settlement Trusts. For tax years ending after enactment, Alaska Native Corporation Settlement Trusts may make a one-time election to apply special income tax rules governing tax rates, distributions, reporting requirements, and disqualifying dispositions.

Tax Credits. Employers that provide child care to employees will be entitled to a general business credit of up to \$150,000 for tax years beginning after 2001.

PENSION CONTRIBUTIONS AND FUNDING

Limits on Contributions to Qualified Plans. The compensation limit that may be taken into account in applying the employer deduction rules and for nondiscrimination testing purposes increases to \$200,000 after 2001. Also, the dollar limit on annual elective deferrals under 401(k) plans, Code Sec. 457 plans, 403(b) annuities, and salary reduction simplified employee pensions (SEPs) is increased to \$11,000 in 2002, with \$1,000 annual increments until it reaches \$15,000 in 2006. The annual limit on elective deferrals for savings incentive match plans for employees (SIMPLE arrangements) gradually increases to \$10,000 in 2005.

Benefit limits under qualified plans. The annual benefit limit under a defined benefit plan is increased to \$160,000 after 2001 and indexed for inflation. The dollar limit is reduced in circumstances where plan benefits begin before the recipient reaches age 62 and is increased for benefits beginning after the recipient reaches age 65. Also, the compensation limit that may be taken into account in determining benefits under qualified plans is increased to \$200,000 after 2001 and indexed for inflation.

Catch-up contributions to IRAs. Beginning in 2002, taxpayers who have attained age 50 can make additional catch-up contributions to their 401(k) plans, 403(b)(3) annuities, SEPs, SIMPLE arrangements, and exempt organization and state or local governmental plans.

Employee contributions. Percentage-of-compensation limitations placed on contributions to qualified retirement plans, which favored highly paid participants, have been eliminated by raising the applicable percentage to 100% of compensation after 2001.

Vesting of employer matching contributions. The minimum vesting standards of a participant's nonforfeitable right in the employer's matching contributions to a retirement plan have been accelerated after 2001.

Repeal of rules coordinating Code Sec. 457 limits with other plan limits. The requirement that the maximum deferral amount for Code Sec. 457 deferred compensation plans offered by state and local governments and exempt organizations be reduced dollar-for-dollar by contributions made to other types of retirement plans has been eliminated after 2001.

Repeal of multiple use test for 401(k) plans. The multiple use test, which is applied to determine whether a Code Sec. 401(k) plan meets nondiscrimination requirements, is repealed after 2001. However, plans that provide elective deferrals and authorize either after-tax employee contributions or employer matching contributions must continue to meet both the actual deferral percentage (ADP) and actual contribution percentage (ACP) nondiscrimination tests.

Contributions by self-employed members of certain religious faiths. After 2001, self-employed individuals who have elected out of the self-employment tax system on religious grounds can treat their exempt self-employment income as compensation from a trade or business for purposes of establishing and contributing to all qualified retirement plans and IRAs, including SIMPLE arrangements.

Deduction of Qualified Plan Contributions. After 2001, the limit on deductible contributions by employers to defined contribution plans has been increased from 15% to 25% of compensation for employees covered by the plan. Money purchase plans are treated in the same manner as stock bonus or profit-sharing plans. Further, the definition of compensation has been modified to increase an employer's deductible contribution under Code Sec. 404 for certain types of plans.

Elective deferrals. After 2001, certain elective deferral contributions will no longer be deemed employer contributions and will not be taken into account in determining an employer's deductible contribution limitation for purposes of computing the employer's deduction for retirement plan contributions.

Household workers. Liability for the 10% excise tax on nondeductible plan contributions has been waived after 2001 with respect to employer contributions to SIMPLE arrangements or SIMPLE IRAs for household workers that are considered nondeductible because they were not made in connection with the employer's trade or business.

Application of deduction rules to all defined benefit plans. The special rule allowing an employer to deduct plan contributions that do not exceed the plan's unfunded current liability has been extended to all defined benefit pension plans, including multiemployer plans and plans with 100 or fewer participants for plan years beginning after 2001.

Qualified After-Tax Roth Contributions to 401(k) and 403(b) Plans. For post-2005 tax years, 401(k) plans and 403(b) annuities may allow participants to elect to have all or a portion of their elective deferrals to the plan designated as after-tax "Roth contributions." An individual's Roth contributions are subject to the Code Sec. 402(g) annual limit on elective deferrals, reduced by the amount of the participant's other elective deferrals under the 401(k) plan or 403(b) annuity. A qualified distribution from a Roth contribution account is not includible in gross income or subject to the 10% penalty on pre-retirement distributions. Further, distributions from a Roth contribution account can be rolled over into another Roth contribution account or Roth IRA. Roth account contributions must be reported on the participant's Form W-2.

Pension Funding Rules. The 160% current liability funding limit increases to 165% in 2002 and to 170% in 2003, and then expires for plan years beginning in 2004.

Excise tax relief. In determining the amount of contributions that are subject to the 10% excise tax imposed on nondeductible plan contributions, after 2001 employers may elect to ignore contributions that do not exceed the accrued liability full-funding limit.

Notice of amendments that reduce benefit accruals. Plan administrators must give participants written notice of amendments to a defined benefit plan made on or after enactment that significantly reduce the rate of future benefit accruals.

Tax Credits. A small employer can claim a credit equal to 50% of the start-up costs incurred to establish or maintain a new employee retirement plan established after 2001. The credit, which is limited to \$500 in any tax year, may be claimed for qualified costs incurred in each of the three years beginning with the tax year in which the plan becomes effective.

Credit for elective deferrals and IRA contributions. From 2002 through 2006, low-income taxpayers can claim a nonrefundable credit for a portion of their retirement plan contributions and deferrals.

User Fees. After 2001, eligible small employers who request an IRS ruling regarding the qualified status of a pension benefit plan within the first five years of the plan do not have to pay user fees.

PENSION DISTRIBUTIONS AND ROLLOVERS

Distributions from Qualified Plans. After 2001, early distributions will be permitted from eligible deferred compensation plans of state and local governments and exempt organizations if they are made pursuant to qualified domestic relations orders.

Purchase of service credits under governmental plans. After 2001, participants in government retirement plans will be able to exclude from income amounts transferred from 403(b) annuities or Code Sec. 457 plans to governmental defined benefit plans for the purpose of purchasing permissive service credits or repaying forfeiture of service credits.

Rollovers disregarded as cash-out amounts. After 2001, the present value of a participant's nonforfeitable accrued plan benefit will not include amounts attributable to rollover contributions.

Minimum distribution and inclusion requirements for Code Sec. 457 plans. The special minimum distribution rules that are applicable to Code Sec. 457 plans sponsored by governmental or tax-exempt employers will be repealed after 2001, and the minimum distribution rules applicable to qualified plans under Code Sec. 401(a)(9) will be extended to Code Sec. 457 plans. Amounts deferred under a state or local government plan will be includible in the recipient's income only upon payment.

Optional forms of benefits. After 2001, the accrued benefits of plan participants or beneficiaries will not be reduced by qualified transfers of benefits to defined contribution plans that do not provide all of the forms of distribution previously available under the transferor plans.

Rollovers. Qualified distributions from, and employees' after-tax contributions to, qualified retirement plans and annuities will generally be eligible for rollover into other types of qualified plans, including 401(k) plans, governmental Code Sec. 457 plans, IRAs, and 403(b) annuities after 2001.

Spousal rollovers. Rules allowing for the rollover of qualified distributions from a decedent's retirement plan into the surviving spouse's IRA will be liberalized after 2001 to allow for rollovers into other types of qualified plans, including 401(k) plans, Code Sec. 457 plans, 403(b) annuities, and IRAs.

Automatic rollovers. Direct rollover into an IRA or other qualified plan will be the default option when

qualified involuntary cash-outs occur after 2001. The participant will be treated as exercising control over the transferred assets upon the earlier of the rollover of any portion of such assets into another plan or one year after the automatic rollover occurs.

Hardship exception to 60-day rollover rule. After 2001, a hardship exception will allow the IRS to waive the requirement that a rollover from a qualified plan or IRA be made within 60 days of the distribution.

Employee Stock Ownership Plans (ESOPs). Changes made to the definitions relating to nonallocation years, disqualified persons, and prohibited transactions are intended to encourage S corporations to form ESOPs that provide broad-based coverage of rank-and-file employees. For plan years beginning after December 31, 2001, the amount allocated to a disqualified person in a prohibited transaction in a nonallocation year will be treated as a distribution, and an excise tax equal to 50% of the prohibited allocation will be imposed against the S corporation.

Reinvestment of ESOP dividends. For tax years beginning after 2001, C corporations will be allowed to deduct dividends that are paid to an ESOP and reinvested in qualified employer securities.

PENSION NONDISCRIMINATION AND COVERAGE RULES

Nondiscrimination and Coverage Rules. Modifications to the definitions of a top-heavy plan and a key employee will reduce the number of plans that qualify as top heavy for tax years beginning after 2001. Also, adjustments to the minimum benefit or contribution rules will reduce the cost to employers.

Definition of highly compensated employee. The current-law general definition of highly compensated employee will remain valid, but a transitional rule enacted by the Tax Reform Act of 1986, which contained a narrowly focused definition of highly compensated employee, will be repealed after 2001.