New Tax Law Includes Provisions Affecting Employee Benefits

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In June 2001, a new acronym was added to the lexicon of employee benefits legislation. The Economic Growth and Tax Relief Reconciliation Act is perhaps best known as the legislation that provided many Americans with a $300 check from the Internal Revenue Service, the result of a retroactive reduction in personal tax rates. The act, now referred to as EGTRRA by some experts, also included many changes to the rules governing employee benefit plansspecifically retirement plans. In general, these new rules are designed to increase available benefits from retirement plans, to increase the amount of income that employees can save in retirement plans, and to provide greater access to retirement benefits for those who change employers.

Defined benefit plans, which specify periodic pension benefits based on a formula, are restricted in the amount of compensation that can be used in determining benefits and are also limited in the annual benefits that may be paid to any one beneficiary. EGTRRA raised both of these limits. For plan years ending after December 31, 2001, compensation up to $200,000 per year may be included in the calculation of benefits, up from $170,000 in 2001. This limit will be indexed to the BLS Consumer Price Index rate of inflation in $5,000 increments in the future. Maximum benefits will rise from $140,000 per year in 2001 to $160,000 for plan years ending after December 31, 2001. This limit also will be indexed to inflation in $5,000 increments.

Similar increases in limits apply to defined contribution plans, which specify how much is placed into an individual employee's account but do not guarantee the amount of benefit available at retirement. The maximum contribution to a defined contribution plan will rise from $35,000 per year in 2001 to $40,000 for plan years ending after December 31, 2001. The maximum compensation included in defined contribution plans will increase just as it does for defined benefit plans.

Maximum employee elective deferrals (pre-tax contributions) to 401(k) plans (and their counterpart 403(b) plans in the public sector) will increase from $10,500 in 2001 to $11,000 in 2002, and by $1,000 increments annually until they reach $15,000 in 2006. After that, this limit will be indexed to the rate of inflation, with increases in increments of $500. Workers age 50 and older will be allowed additional pre-tax contributions beginning in 2002. These additional contributions begin at $1,000 per year in 2002 and rise annually to $5,000 per year in 2006. In addition, these added contributions will not be subject to nondiscrimination rules, which often restrict how much one individual can save on a pre-tax basis. (Nondiscrimination rules compare the pre-tax contributions of employees at different compensation levels; they are designed to limit the tax advantage available to highly compensated employees so that it does not greatly exceed the tax advantage available to less highly-compensated employees.)

EGTRRA also expanded the allowable contributions to Individual Retirement Accounts (IRAs), which can be established by employees and their spouses independentlythat is, not through their employer. IRAs are related to employment, however, as individuals must have income from employment to establish an IRA and the tax advantages of these plans vary by an employee's income and participation in an employer retirement plan. Allowable contributions to IRAs will increase from $2,000 per year in 2001 to $5,000 per year in 2008, after which the contribution limit will be indexed for inflation. The law also established a new tax credit for low income individuals who contribute to an IRA.

Finally, EGTRRA lowers the number of years that individuals must participate in certain types of employer retirement plans before they are vested. Vesting is the guarantee of benefits from a plan, regardless of whether or not the individual leaves the employer prior to retirement. When first imposed by the Employee Retirement Income Security Act of 1974 (ERISA), vesting had to occur after no later than 10 years, or after 15 years if the plan provided graduated vesting. For example, under a graduated vesting schedule, the employee might be 25 percent vested after 5 years, with the percent increasing annually until reaching 100 percent vested after 15 years. Over time, Congress has reduced the maximum number of years that could be included in a vesting schedule. Under the new law, vesting of employer matching contributions to a defined contribution plan must occur after 3 years (cliff vesting), or after 6 years if a graduated schedule is used.

Most of these changes to benefit plans became effective in 2002, although such changes may not take effect until the beginning of the plan year as designated by the plan. Also, there are often different rules for collectively bargained plans. The Bureau of Labor Statistics publishes data on retirement plans and their provisions; future survey results will indicate how employers have changed their plans to accommodate the new law.

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