Pensions, State Taxes and the 2001 Act

by Peter James Lingane[1]
Presented to the East Bay Association of Enrolled Agents, October 17, 2001
Updated October 29, 2001

Summary

Dear Small Business Owner,

I want to tell you about changes in the law that will let you simplify pension administration.

You originally chose a paired pension plan so that you would be able to contribute more on your own behalf. Under the 2001 Act, you no longer need two plans. Everything that you could do before with two plans you can do now with one 401(k) plan.

Sincerely,

Sales Representative

Dear Sales Representative,

I discussed your suggestion with our pension administrator and her response was "Over my dead body!" The 2001 Act eases the administrative burden exactly as you suggest but our state taxes will continue to be determined under the old rules. Merging the plans as you recommend could expose me and my firm and my employees to extra state taxes.

Sincerely,

Small Business Owner

Introduction

Planners and financial firms are enthusiastic about the improved contribution limits and rollover opportunities provided by HR 1836, "The Economic Growth and Tax Relief Reconciliation Act of 2001." But the 2001 Act requires complementary legislative changes in about forty percent of the states[2]. So, next time a customer asks what the 2001 Act means for them and for their

---

[1] Peter James Lingane is licensed as a tax professional by the federal government and as a planning professional by the Certified Financial Planner Board of Standards. Peter limits his practice to investment and estate planning. He also teaches at a community college and volunteers with the Tax Counseling for the Elderly program. Peter can be reached at (925) 299-0472 or via lingane@post.harvard.edu.

[2] This estimate was inferred from information in the "2001 State Tax Handbook," CCH Incorporated and is not considered authoritative. Thirty of the states and the District of Columbia impose no income taxes or automatically conform to changes in the Internal Revenue Code. Twelve states (Arizona, Georgia, Hawaii, Idaho, Iowa, Kentucky, Maine, Michigan, Minnesota, North and South Carolina and West Virginia) are current with the Internal Revenue Code and might be expected to adopt the 2001 Act in a timely fashion. Changes in state law are more problematic in nine states: Arkansas, California, Indiana, Mississippi, Montana, New Hampshire, New Jersey, Texas and Wisconsin.

Check with a tax practitioner to confirm the situation in your locality.

business, your answer should be “trouble” if you practice in a locality which does not routinely conform to changes in the Internal Revenue Code (IRC.)

I begin with the current rules and the changes effected by the 2001 Act[3]. The examples are designed to illustrate the benefits of the federal changes and the impact of state nonconformity. The examples are specific to California but they should provide a flavor of what may happen in other nonconforming localities.

I conclude by suggesting areas where partial conformity would resolve the more egregious issues without loss of current revenue[4].

The treatment is incomplete, and doubtless contains errors. The reader is encouraged to confirm the information herein with primary sources. Please advise the author of errors/clarifications so that the web version of this article[5] can be updated.

In General

The 2001 Act allows larger contributions to pensions and IRAs and extra "catch-up" contributions to older individuals. The 2001 Act also makes it possible to move money more freely among pensions and IRAs.

Because US tax law is so complex, relatively straightforward changes require numerous amendments to the Internal Revenue Code. Inevitably, there are mistakes. Congress appears to have inadvertently repealed "Crummey powers" for example[6], and they apparently forgot to change a key statute affecting Simplified Employee Pensions (SEPs.) More on SEPs later.

The 2001 Act also allows larger contributions to Education IRAs, eases the rules on moving money from one 529 plan to another and among family members and changes penalties and the definition of qualified distributions[7]. There is also a credit designed to stimulate participation by lower income taxpayers. More later on education incentives and the new pension credit.

---

[3] The Congress produced an excellent report contrasting the 2001 Act and existing law. The pdf version of House Report 107-84 will be referred to as the "Conference Report" and can be downloaded from http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_reports&docid=f:hr084.107.pdf.

[4] Revenue is especially acute here in California where we have yet to figure out how to pay for last Spring's power outages or how to replace the revenue from employer stock options. Kimberly Bott, Chief Consultant to the California Assembly Committee on Revenue and Taxation, and Martin Helmke, Tax Consultant to the California Senate Committee on Revenue and Taxation, predicted that full conformity was unlikely in remarks to the California Society of Enrolled Agents on June 28, 2001.

[5] www.lingane.com/tax/seminars/pension_rules.pdf.

[6] §511(e) of the 2001 Act adds IRC §2511(c). "... except as provided in regulations, a transfer in trust shall be treated as a taxable gift under section 2503 unless the trust is treated as wholly owned by the donor or the donor's spouse ...." This new provision is effective after 2009.

[7] "Planning Strategies Under the Education Provisions of the New Tax Act," Joseph F. Hurley, *Journal of Financial Planning*, **14**(9), September 2001, p. 116-128.

Changes with respect to IRAs and education incentives begin to take effect in January 2002. The changes to employer pensions generally take effect when - and if - the employer adopts the new provisions[8].

Overview of Pension Plans

The usual rule[9] is that an employee is not taxed on fringe benefits, and the employer is not able to take a deduction for the cost of funding the benefits, until such time as the benefits are guaranteed. Contributions to executive plans defer current taxation according to this principle.

Pensions for the rank and file are generally protected from creditors and the employee generally has a vested right to the contributions. Nonetheless, tax on the contributions, and on the earnings on the contributions, is deferred[10] and the employer can claim a current deduction because of specific exemptions in the Internal Revenue Code.

"Qualified plans" are pensions which follow the numerous rules in IRC §401(a) and in the Employee Retirement and Income Security Act of 1974 (ERISA.) These include employer sponsorship, a written plan, a separate trust, protection from creditors, broad participation, limits on the benefits for highly paid employees, vesting schedules, required distributions, contribution limits, rollovers and the right of a spouse to veto rollovers and beneficiary designations.

The employer sponsorship requirement originally meant that the self employed could not establish a qualified plan but Congress has gradually eliminated most differences[11]. A "Keogh plan" is a qualified plan for the self employed.

Qualified plans are classified as either a defined benefit or as a defined contribution plan. With a defined benefit plan, the employer is responsible for making big enough contributions and good enough investment decisions so that trust assets are large enough to pay future benefits based on each employee's salary history, years of service and retirement age.

Currently, defined benefit plans are limited to paying pensions no larger than 100% of an employee's average compensation or $140,000[12], with an adjustment if retirement occurs before or after the Social Security retirement

---

[8] Alex Brucker, in remarks to the *2001 New Tax Law Conference* sponsored by the California CPA Education Foundation, warned that those defined benefit plans whose fiscal year ends after January 1, 2002 could be forced to fund the new higher benefits immediately.

[9] IRC §83(a)

[10] Contributions to a Roth IRA are taxed but the earnings Roth IRA are tax exempt.

[11] There are subtle differences between qualified and Keogh plans in premature distribution penalties and in the basis in insurance maintained by a plan on the participant's life. See Natalie Choate's' November 1999 newsletter at www.ataxplan.com/notes_frame/note_frame.htm.

[12] IRC §415(a) adjusted for inflation.

age. The employer's deduction for annual additions to a defined benefit plan is limited to the actuarially determined amount needed to fund future benefits.

The 2001 Act increases the maximum defined benefit pension payment to $160,000 annually. In addition, it will be possible to retire at age 62 with no decrease in benefits[13]. The combined effect of these changes is to substantially increase lump sum benefits at retirement.

Defined contribution plans limit the employer's obligation to paying into the pension trust and can shift responsibility for investment decisions to the employee. Pension payments are not determined by a formula but depend on actual investment performance.

Other pensions are "non qualified." This does not mean that they lack tax advantages but only that they are governed by different Code sections.

Pensions differ with respect to how much can be contributed, how much can be deducted, the definition of compensation, elective deferrals and rollover opportunities. We will address these issues presently.

In addition, pensions differ with respect to, allowable investments, loan provisions, creditor protection, penalties, required distributions and beginning dates, withholding requirements and community property rights[14]. The practitioner must never assume that a transaction is tax-free or penalty-free based on general knowledge but should confirm the correct treatment by determining the Code sections governing the plan or, better yet, reviewing the actual plan document.

<u>How Much Can Be Contributed?</u>

Contributions to executive plans are limited by the generosity and ingenuity of the employer. Contributions to IRAs and SIMPLE plans are limited by both a dollar amount and by a percentage of compensation. Qualified plans and SEPs are further limited by what the employer can deduct. (Limits on the employer's deduction are not relevant for tax sheltered annuities and 457 plans since these are sponsored by employers who do not pay income taxes.)

---

[13] Conference Committee report, pp. 211-212.

§415(e), which had imposed restrictions on contributions to defined benefit and defined contribution plans maintained by the same employer, was recently repealed. Chris Caul of Pension Reporting Systems, Oakland, CA predicts that repeal will motivate employers to establish both defined benefit and money purchase plans for highly paid, under thirty-five year olds.

[14] The Supreme Court said, in Boggs 1997, that ERISA trumps state community property law. Thus, a non participant spouse cannot direct a community property interest in the surviving spouse's 401(k) plan to his or her heirs but probably can direct the disposition of the community property interest if the pension has been rolled over to an IRA.

Traditional and Roth IRAs[15]. IRA contributions are currently limited to the smaller of $2,000 or 100% of compensation. Compensation is defined as taxable income from personal services plus alimony[16].

If a taxpayer contributes to both a traditional and a Roth IRA, the limit applies to the combined contributions. In the case of a couple filing jointly, the compensation can be earned by either spouse. Contributions to a traditional IRA are not allowed after age 70½. Contributions may be pre-tax depending on marital status, AGI and pension participation.

Contributions to a Roth IRA can be made at any age but are limited by AGI and filing status. You can convert a traditional IRA to a Roth IRA by paying the deferred tax so long as your modified AGI does not exceed $100,000 and so long as your filing status is not married filing separately.

The 2001 Act increases the combined contribution limit to $3,000 in 2002 and to larger amounts in subsequent years[17]. In addition, participants aged 50 and over are permitted extra "catch-up" contributions, *vide infra*.

The 2001 Act makes no changes to the AGI limitations on pre-tax contributions to a traditional IRA, to the AGI limitations for contributing to a Roth IRA or to the AGI limitation for converting to a Roth IRA.

SIMPLE IRA and 401(k) Plans[18]. Contributions take the form of an elective employee deferral plus an employer contribution. Employee deferrals are currently limited to the smaller of $6,500 or 100% of compensation. Compensation is W-2 wages plus elective deferrals; i.e., gross compensation. For the self-employed, compensation is net self employment income with no correction for the pension contribution.

Employers must either

- Match each employee's deferral dollar for dollar up to 3% of compensation.
- Or, contribute 2% of compensation on behalf of each eligible employee. Compensation for purposes of the mandatory employer contribution is currently limited to $170,000[19], the "401(a)(17) limit."

The employer's deduction to a SIMPLE IRA is not limited but the deduction to a SIMPLE 401(k) is currently limited to 15% of aggregate taxable compensation[20].

The 2001 Act increases deferrals to $7,000 with further increases to $10,000 by 2005[21]. Older employees are allowed "catch-up" deferrals, *vide infra*.

---

[15] IRS Publication 17, Chapter 18.

[16] IRC §219(f).

[17] IRC §219(b) as amended by the 2001 Act. The IRA limit is called the "combined deductible amount."

[18] IRC §408(p) or IRS Publication 560. Restricted to smaller employers with no other pension plan.

[19] IRC §408(p)(2)(B)(ii).

[20] IRC §404(m). See also the 404(a) and 404(j) tests, *vide infra.*

The 2001 Act also increases the 401(a)(17) limit to $200,000. The employer deduction to a SIMPLE 401(k) plan is increased to elective deferrals plus 25% of compensation and "compensation" is increased to gross compensation.

SEPs. SEPs contributions are currently limited to the smaller of $35,000[22] or 15% of compensation[23]. An older plan might include elective deferrals[24].

The definition of compensation follows the definition for qualified plans: taxable compensation plus elective deferrals to pensions and to 125 plans[25]. Considered compensation cannot exceed the 401()a)(17) limit[26].

Employers can deduct the smaller of actual contributions or 15% of the aggregate compensation[27] of all employees. The compensation considered for any one employee is limited to the 401(a)(17 limit[28], currently $170,000.

The 2001 Act increases the dollar contribution limit to $40,000, increases considered compensation to $200,000, increases the elective deferral limit to $11,000 and increases the employer deduction to 25% of compensation.

The 2001 Act did not increase the 15% cap on employee contributions. The impact will be illustrated in a subsequent example. My guess is that this glitch will be fixed by a technical correction.

Salary reduction SEPs are permitted "catch-up" contributions, *vide infra*.

Tax Sheltered Annuities or 403(b) Plans. The employer must be a 501(c)(3) tax exempt organization or must be part of the public education system. Private schools are included if they qualify as tax exempt organizations.

As originally constituted, a 403(b) plan was distinct from a defined contribution plan. Over the years, the differences in investment vehicles and elective deferrals have been eroded. The 2001 Act accelerates the convergence process by changing the contribution limits and catch-up provisions.

For example, 403(b) contributions are invested in deferred annuity contracts offered by an insurance company and these are different from the mutual funds generally offered by defined contribution plans. Insurance companies now commonly offer variable annuities based on clones of popular mutual funds and so the only practical differences from defined contribution plans tend to be different fee structures and different ticker symbols.

---

[21] IRC §408(p)(2) as amended by the 2001 Act.

[22] IRC §408(j) references the 415(c)(1)(A) limit.

[23] IRC §402(h). Excess contributions are taxable to the employee and subject to a 10% annual penalty.

[24] IRC §408(k)(6)(H). Salary reduction SEPs were repealed when SIMPLE plans were instituted in 1996.

[25] IRC §408(k)(7)(B)

[26] The §401(a)(17) limit does not apply directly but §§408(k)(3)(C) and 408(k)(8) produce the same result.

[27] IRC §404(h)(1)(C).

[28] IRC §§404(h)(1)(C) and 404(l).

There are additional 403(b) requirements[29] which will not be discussed here.

Contributions cannot exceed the smaller of an "exclusion allowance" or the 415(c) limit, *vide infra*. Defined contribution plans are limited by 415(c).

The exclusion allowance in a given year is generally 20% of cumulative compensation[30] less prior pre- and after-tax 403(b) contributions by the same employer, less prior pre-tax qualified plan contributions by the same employer, less prior contributions to a 457 plan maintained by the same or other employer[31]. If there is more than one current employer, the employee is entitled to an "exclusion allowance" calculated separately for each employer.

Compensation for the purposes of the exclusion allowance means taxable compensation[32]. Considered compensation is limited to the 401(a)(17) limit[33].

The 2001 Act eliminates the exclusion allowance concept[34] with the result that future contributions to both 403(b) annuities and defined contribution plans will be limited by 415(c).

Elective deferrals are limited by 402(g). The 2001 Act increases the 402(g) limit to $11,000 with further increases to $15,000 in later years.

Older participants are currently permitted larger contributions. The 2001 Act repeals the special rules for 403(b) plans in favor of more generally applicable "catch-up" deferrals, *vide infra*.

457 Deferred Compensation Plans. These plans are sponsored by state and local governments and by tax exempt organizations other than churches and church-controlled organizations[35]. Many of these same employers sponsor 403(b) annuity plans.

457 deferred compensation plans are special in that

- Contributions take the form of voluntary salary reductions with no employer contributions, matching or otherwise.

---

[29] "The Pension Answer Book" as updated periodically by Panel Publishers.

Required distributions from tax sheltered annuities follow the rules for IRAs and qualified plans except that it may be possible to delay the distribution of benefits accrued before 1987 beyond age 70½. Prop. Reg. 1.403(b)-2, Q-2 as revised January 17, 2001.

[30] IRC §403(b)(2)

[31] "The Pension Answer Book," *op. cit*.

[32] IRC §403(b)(3)

[33] IRC §§403(b)(1)(D) and 403(b)(12).

[34] Conference Committee report, pp. 237 - 240

[35] IRC §§457(e)(1) and 457(e)(13). Church-controlled hospitals can usually sponsor 457 plans but seminaries, retreat centers and burial societies cannot because they don't offer services to the public.

- Assets are generally subject to claims[36] by the employer's creditors. However, assets in governmental plans are insulated from creditors.
- A non increasing life annuity is the only distribution method[37]. The 2001 Act repeals[38] this special rule and makes the 457 distribution rules the same as for IRAs and other pensions.

The current contribution limit is the smaller of one third of compensation or $8,500[39]. The dollar amount is doubled in the three years before retirement and is reduced[40] by elective deferrals to 401(k), 403(b), SEP and SIMPLE plans.

The 2001 Act increases the contribution limit[41] to $11,000 next year, schedules further increases to $15,000 in 2006, and increases the percentage limit to 100% of compensation[42].

The one third of compensation limit may appear to be more generous than the one fourth of compensation allowed SEP and defined contribution plans. This is an illusion since compensation means taxable compensation[43] in the context of a 457 plan and one third of taxable compensation is algebraically equivalent to one fourth of gross compensation. The 100% limit in the 2001 Act will effectively limit 457 contributions to one half of gross compensation.

The 2001 Act allows "catch-up" deferrals to governmental 457 plans, *vide infra*.

<u>Defined Contribution Plans.</u> There are separate limits on how much can be contributed on behalf of each employee, on how much of this contribution can be in the form of elective deferrals and on how much the employer can deduct.

- The 415(c) limit. Contributions are currently limited to the smaller of $35,000 or 25% of compensation[44].

  This limit is per employer, meaning that a single limit applies to all defined contribution plans plus all SEPs and, potentially, all 403(b) plans maintained by the same employer[45]. Contributions on behalf of a high income individual to the plans of several employers, or to employer and self employment plans, can exceed $35,000.

---

[36] IRC §§457(b)(6) and 457(g). The trust requirement may stem from the Orange County bankruptcy.

[37] IRC §457(d)(2)(C)

[38] IRC §457(d)(2) as amended, effective 2002.

[39] IRC §457(b)(2) as adjusted for inflation.

[40] IRC §457(c)(2)

[41] Congress did not reference the contribution limit to the 402(g) limit. Consequently, after 2006, there could be differences between the adjusted exclusion amount and the adjusted 402(g) limit.

[42] IRC §457(b)(2)(B) as amended by the 2001 Act.

[43] IRC §457(e)(5). This statute was not affected by the 2001 Act.

[44] IRC §415(c) adjusted for inflation.

[45] IRC §§415(f)(1)(B), 404(h)(2) and Reg. 1.415-8 respectively.

Compensation is defined as taxable compensation plus elective deferrals to pensions and to 125 plans[46]. The maximum compensation that can be considered for any one employee is currently $170,000[47].

The 2001 Act increases the 415(c) limit to the smaller of $40,000 or 100% of compensation and increases the 401(a)(17) limit on considered compensation to $200,000.

- The 402(g) Limit on Elective Deferrals. Pre-tax employee contributions are called "elective deferrals" and are currently limited to $10,500[48]. This is a per employee limit, meaning that if an employee makes elective deferrals to more than one defined contribution plan with the same or several employers, the dollar limit applies to the aggregate of all deferrals.

  The 402(g) limit also applies to 403(b) and SEP plans.

  The 2001 Act increases the 402(g) limit to $11,000 in 2002 and to $15,000 by 2006. In addition, employees aged 50 and over are permitted extra "catch-up" contributions, *vide infra*.

- An employer is generally allowed a full deduction on their tax return for actual additions to defined contribution plans.

  A defined contribution plan which allows discretionary contributions is classified as a profit sharing plan. 401k plans and ESOPs are common examples. Classification as a profit sharing plan limits the employer deduction to 15% of the aggregate compensation of eligible employees. This will be referred to as the "404(a) limit."

  Compensation is defined as total compensation less elective deferrals to pensions and 125 plans[49]. This is different from the definition used to limit contributions under 415(c). Compensation on behalf of any one employee is limited by 401(a)(17)[50].

- An employer can establish "paired" plans so that more money can be contributed without running afoul of the 404(a) limit.

  For example, an employer might make non discretionary 10% contributions to a "money purchase" plan and establish a 15% discretionary "profit sharing" plan. Twenty five percent could be contributed on behalf of each

---

[46] IRC §415(c)(3).

[47] IRC §401(a)(17) adjusted for inflation. This limit also affects discrimination testing.

[48] IRC §402(g), adjusted for inflation. Elective deferrals to 401k plans, 403b annuities, SIMPLE and 457 plans sponsored by multiple employers on behalf of the same employee must all squeeze inside this cap.

Elective deferrals to SEP plans are limited by §402(g) but do not limit elective deferrals to other plans.

There is no penalty *per se* if deferrals exceed the §402(g) limit. But the excess deferral will be taxed twice, once in the current year and once again when distributed. See §402(g)(7).

[49] Reg. 1.404(a)-9(b); Rev. Rul. 80-145

[50] IRC §404(l)

employee in a good year while allowing the employer to reduce contributions to 10% in a bad year.

The 2001 Act eliminates the distinction between profit sharing and other defined contribution plans purposes of the 404(a) test. Contributions to all defined contribution plans are limited to 25% of compensation beginning in 2002. This represents an increase for profit sharing and ESOP plans and a new cap for other defined contribution plans.

The practical effect of this change is to eliminate the need for paired plans. For federal purposes, everything that could be done with a paired plan can be done with a single 401(k) plan beginning next year.

In addition, the definition of compensation for purposes of the 404(a) test is changed from taxable compensation to total compensation[51]. This definition is now the same as that used in §415(c) to limit contributions and insures that elective and catch-up deferrals are deductible by the employer.

- The employer contribution is further limited to the sum of the maximum amounts that can be contributed on behalf of each employee. This is referred to as the "404(j) limit."

  Due to the changes to §415(c), the 404(j) test becomes the sum, per employee, of the smaller of 100% of compensation or $40,000.

  The effect of the 404(a) and 404(j) limits will be illustrated by the deduction for ABC Corporation, *vide infra*.

  The employer is hit with a 10% penalty[52] on non deductible contributions which exceed the smaller of the 404(a) or 404(j) limits[53].

[51] IRC §404(a)(13), added by the 2001 Act.

[52] IRC §4972

[53] IRC §404(a)(3). More precisely, the limit is 15% of the taxable compensation of all employees covered by the plan with the compensation considered for any one employee being limited by §401(a)(17). As used here, compensation does not include elective deferrals to pensions and to §125 plans.

Profit sharing plans could contribute, or allow employees to contribute, more than 15% of their individual taxable compensation without tax or penalty so long as the aggregate contributions for all employees is less than 15% of the aggregate compensation. Few do however.

Pension Limits as Modified by the 2001 Act

"Compensation" is uniquely defined for each limit and can have different meanings within the same pension type. "Catch-up deferrals are not included within these limits.

	Tax Year 2001	Tax Year 2002
Defined Benefit Plan		
Maximum Annual Pension	$140,000 or 100%	$160,000 or 100%
Employer Deduction	Actuarially Required	Actuarially Required
Defined Contribution Plan		
Maximum Contribution	$35,000 or 25%	$40,000 or 100%
Employer Deduction	$35,000 or 25%	$40,000 or 25%
Profit Sharing Plan		
Maximum Contribution	$35,000 or 25%	$40,000 or 100%
Employer Deduction	$35,000 or 15%	$40,000 or 25%, plus deferrals
Elective Deferrals	$10,500 or 25%	$11,000 or 100%
403(b) Annuity		
Maximum Contribution	$35,000 or 20±%	$40,000 or 100%
Elective Deferrals	$10,500 or 20±%	$11,000 or 100%
457 Elective Deferrals	$ 8,500 or 33.3%	$11,000 or 100%
Traditional and Roth IRA	$ 2,000 or 100%	$ 3,000 or 100%
SIMPLE		
Maximum Contribution[54]	$13,000 ($ 9,900)	$14,000 ($11,000)
Employer Deduction	15%[55]	25% plus deferrals
Elective Deferrals	$ 6,500 or 100%	$ 7,000 or 100%
SEP		
Maximum Contribution	$35,000 or 15%	$40,000 or 15%
Employer Deduction	$35,000 or 15%	$40,000 or 25%, plus deferrals
Elective Deferrals	$10,500 or 15%	$11,000 or 15%
§401(a)(17) Limit	$170,000	$200,000

Catch-Up Deferrals

The 2001 Act allows additional deferrals to those who attain age 50 by the end of the tax year and who participate in an IRA or in any elective deferral plan except a 457 plan sponsored by a tax exempt employer[56].

---

[54] The maximum elective deferral plus a matching employer contribution.

Alternatively, employers can make mandatory contributions of 2% of compensation up to the §401(a)(17) limit. This alternative limits contributions to $6,500 + 2% * $170,000 = $9,900 in 2001 and to $7,000 + 2% * $200,000 = $11,000 in 2002.

[55] IRC §404(m).

[56] IRC §414(v)(6)(A)(iii), added by the 2001 Act.

Since SEPs established after 1996 are not permitted elective deferrals[57], participants in post-1996 SEPs are not allowed catch-up deferrals[58].

The catch-up deferral is the smaller of compensation (reduced by any other elective deferrals) or the applicable dollar amount shown in the following table.

	The applicable dollar amount is	
	Traditional and Roth IRAs[59] and SIMPLE and 401(k)(11) plans[60]	Defined contribution and 403(b) plans, SARSEPs, governmental 457 plans[61]
2002	$500	$1,000
2003	$1,000	$2,000
2004	$1,500	$3,000
2005	$2,000	$2,000
2006	$2,500	$5,000
Thereafter	$2,500 plus COLA	$5,000 plus COLA

All employees in all plans maintained by the same employer, or no employee in no plan, must be allowed catch-up deferrals[62]. It's all or nothing.

Catch-up deferrals do not count against the 402(g), 404(a) or 415(c)(1)(A) limits[63]. An employer is allowed but not required to match catch-up deferrals but any employer match is counted when testing the 404(a) and 415(c) limits.

EXAMPLE. Alison is a highly compensated employee. Her elective deferral to her employer's 401(k) plan is limited to $8,000 by the non discrimination rules.

Alison is aged fifty. She is permitted an additional $1,000 catch-up deferral on her 2002 tax return. The non discrimination rules do not apply to this deferral.

---

[57] IRC §408(k)(6)(H).

[58] IRC §414(v)(1) reads "An applicable employer plan shall not be treated as failing to meet any requirement of this title solely because the plan permits an eligible participant to make additional elective deferrals in any plan year." Because of the reference to *additional deferrals*, I conclude that the plan must allow elective deferrals. SEPs instituted after 1997 would not qualify.

§414(v)(3)(B) reads "except as provided in paragraph (4), such plan shall not be treated as failing to meet the requirements of section 401(a)(4), 401(a)(26), 401(k)(3), 401(k)(11), 401(k)(12), 403(b)(12), 408(k), 408(p), 408B, 410(b) or 416 by reason of the making of (or the right to make) such contribution." On the face of it, this appears to eliminate the 408(k)(6)(H) prohibition against new elective deferral SEPs. However, paragraph 4 and the referenced sections have to do with discrimination testing.

Thus 414(v)(3)(B) could be interrupted as not affecting 408(k)(6)(H) because 408(k)(6)(H) does not address discrimination testing.

[59] IRC §219(b)(5)(B) was added by the 2001 Act.

[60] IRC §414(v)(2)(B) was added by the 2001 Act. This is also known as a "SIMPLE 401(k) plan."

[61] IRC §414(v), added by the 2001 Act. These catch-up provisions do not apply to 457 plans in the three years before retirement when deferrals are already doubled by existing law; see §414(v)(6)(C).

[62] IRC §414(v), added by the 2001 Act.

[63] IRC §404(v)(3), added by the 2001 Act.

An employee is permitted multiple catch-up deferrals to multiple plans.

EXAMPLE. Martin participates in a SIMPLE plan with his employer and in a paired defined contribution plan based on his self-employment income. Martin is aged fifty.

Martin's elective deferrals to the SIMPLE and paired plans are limited to a total of $11,000 in 2002. Martin's consulting business is very successful and he is able to contribute $40,000 to the paired plan. This is the maximum under 415(c)(1)(A).

Martin is permitted an additional $1,000 catch-up deferral to the paired plan and an additional $500 catch-up deferral to the SIMPLE plan.

EXAMPLE. SEPs are limited under the 2001 Act by the 15% cap on employee contributions[64]. Any elective deferral is included in the 15% cap.

401(k) plans are limited by the 25% cap on employer deductions. Any elective deferral is in addition to the 25% cap.

The 15% and 25% limits become 13% and 20% limits with respect to self employment income[65].

SEPs have been the plan of choice for self employed individuals because one can contribute as much as to a 401(k) plan but SEPs cost less to administer Let's compare one person plans under the provisions of the 2001 Act. These comparisons assume that the SEP plan is not permitted elective deferrals.

	SEP	401(k)
Limits		
Percentage	13%	20% plus deferral
Dollar	$40,000	$40,000
Elective Deferral	None	$11,000
Catch-up Deferral	None	If applicable
Income		
$100,000	$13,000	$31,000
$150,000	$19,500	$40,000
$200,000	$26,000	$40,000
$250,000	$26,000	$40,000

---

64 Contributions above 15% are not going to happen because they would be taxable income to the employee and subject to a 10% annual penalty until withdrawn. The 15% limit is set in §402(h).

65 IRC §401(c)(2) defines compensation for defined contribution plans and SEPs as net earnings subject to self employment tax (or that would be subject to tax except for a religious exemption) less one half the self employment tax less the pension deduction under §404. Neglecting the self employment tax and doing the algebra, 15% becomes 0.15/1.15 or 13.043% and 25% becomes 0.25/1.25 or 20.000%.

IRC §408(p)(6)(A)(ii) defines compensation for SIMPLE plans as net earnings from self employment with no reduction for self employment tax or for SIMPLE contributions.

For $100,000 in self employment income, SEP contributions are limited to about $13,000. 401(k) plan contributions are substantially higher - $20,000 plus an $11,000 elective deferral - and could be higher still if the participant were aged 50 or older.

More can be contributed to either plan at higher incomes. Substantially more can always be contributed to the 401(k) plan at any income level. These conclusions have stimulated at least one firm to refocus their marketing towards one person 401k plans[66].

EXAMPLE: ABC Corporation, a small business, has a money purchase plan paired with a 401(k) plan. These require a 10% employer contribution and allow elective deferrals with a 50% employer match. The comparisons shown below convince ABC Corporation to eliminate the money purchase element for administrative convenience.

The 401(k) element is revised to provide a 10% employer contribution plus a 50% employer match of elective deferrals plus unmatched catch-up deferrals. The revised plan limits matched deferrals to 10% of salary or $11,000[67] and limits annual additions on behalf of each employee to the smaller of 25% of salary or $40,000[68]. The existing percentage of salary limit is eliminated since this was repealed by the 2001 Act[69].

The plan includes the appropriate rules so that there is no discrimination on behalf of highly compensated employees. Discrimination testing is neglected in this example.

Next year, annual additions for the firm's three employees would be as follows under either the existing paired plan or a reconstituted 401(k) plan.

	Compensation	Elective Deferral	Employer 50% Match	10% Employer Contribution	Total Additions
John	$200,000	$11,000	$5,500	$20,000	$36,500
Judy	60,000	6,000	3,000	6,000	15,000
Jane	20,000	2,000	1,000	2,000	5,000
Total	$280,000	$19,000	$9,500	$28,000	$56,500

John's elective deferral is the maximum permitted by 402(g) as revised by the 2001 Act. Elective deferrals by Judy and Jane are well below this limit. No annual addition on behalf of any of the three employees exceeds the 415(c) limits under the 2001 Act.

ABC Corporation may deduct the smallest of

- Total additions on behalf of all employees, $56,500.
- The 404(a) limit. 25% of aggregate compensation or $70,000 plus $19,000 worth of elective deferrals.

[66] "The One-Man Band Gets a 401(k) Gift," Karen Damato, *The Wall Street Journal*, August 17, 2001, C1.

[67] IRC §402(g) as amended by the 2001 Act.

[68] IRC §404(a)(3)(A) and §415(c)(1)(A) as amended by the 2001 Act.

[69] IRC §415(c) as amended by the 2001 Act.

- The 404(j) limit, the sum of the amounts that could be contributed on behalf of each employee under 415(c) plus $19,000 of elective deferrals. The 404(j) limit is $119,000, computed as $40,000 (John) plus $40,000 (Judy) plus $20,000 (Jane) plus elective deferrals.

ABC Corporation may deduct deferrals plus $37,500. A full deduction is allowed.

Rollovers

The IRS distinguishes between trustee to trustee transfers and situations where the participant takes a distribution and deposits the money with a new trustee within 60 days. This distinction is neglected here but it is important[70].

Current law allows you to move funds from

- A traditional or Roth IRA at one financial institution to a traditional or Roth IRA at another institution.
- A qualified plan, 403(b) annuity or 457 plan to the same type of plan with another employer.
- A SIMPLE-IRA to another. A SIMPLE-IRA may also be rolled over to a traditional IRA two years or more after first participating in the plan.
- A SEP may be rolled over to a traditional IRA.
- A qualified plan or 403(b) annuity may be rolled over to a traditional IRA if the plan ends or when the employee separates from service or at age 59½.
- A traditional IRA may be converted to a Roth IRA if modified adjusted gross income is less than $100,000 and filing status is not married filing separately. Conversion triggers recognition of deferred income.

Current law forbids rollovers from

- A qualified plan to a 403(b) annuity or from a 403(b) annuity to a qualified plan.
- An IRA to a qualified plan or 403(b) annuity unless the IRA originated as a rollover from a qualified plan or 403(b) annuity and has not been

---

[70] There is no limit on the frequency of trustee to trustee transfers but only one rollover is permitted in any twelve month period, inherited assets cannot be rolled over but can be moved trustee-to-trustee; rollovers from a qualified plan are subject to withholding but trustee to trustee transfers are not.

Rollovers allow participants to move their money from a plan with limited investment options or high fees to an environment where the savings will grow faster or grow with a more appropriate level of risk.

Rollovers allow multiple plans to be consolidated. This eases administration, reduces the potential for errors and penalties and simplifies minimum distribution and estate planning.

Rollovers permit pensions to be converted to Roth IRAs, thereby setting aside more money for retirement, reducing estate tax, providing security for the participant and their heirs - and accelerating tax revenues.

A rollover to a qualified or 403(b) plan allows the participant to access loan privileges, to delay minimum distributions past age 70½ and to accelerate penalty free distributions to age 55. Such a rollover might also protect the savings of a younger person who would otherwise lose their pension in bankruptcy.

commingled with other IRA contributions. This special IRA is known as a "conduit IRA."

- A 457 plan to an IRA, qualified plan or 403(b) annuity or from an IRA, qualified plan or 403(b) annuity to a 457 plan.

A spouse may roll a distribution from a decedent's IRA or qualified or 403(b) plan into an IRA in their own name but not into their own qualified or 403(b) plan. The spousal rollover privilege does not currently apply to distributions from 457 plans.

The 2001 Act generally permits rollovers among all types of plans[71] so long as there are special accountings for any Roth contributions. The exception is rollovers to and from 457 plans sponsored by tax exempt organizations. The spousal rollover privilege is extended to governmental 457 plans.

EXAMPLE. Albert lost his job as part of the dot com retrenchment along Silicon Highway outside Boston. He rolled his qualified plan assets into an existing IRA.

It took Albert almost a year to secure new employment but he was working again before his financial situation entirely deteriorated. His brush with bankruptcy sensitized him to the limited creditor protection afforded IRAs and he therefore rolled his IRA into a qualified plan with his new employer. Prior to the 2001 Act, the rollover of an IRA to a qualified plan was restricted to a "conduit" IRA.

Distribution Options for 457 Plans

Currently, distributions must be in the form of a non increasing life annuity beginning by the calendar year in which the participant turns age 70½[72].

EXAMPLE. Alice, a retired nurse, has $200,000 in County Hospital's 457 plan. She is concerned that her only option is to convert her pension to a life annuity[73] when it becomes time to take mandatory distributions. She is unhappy with the fees charged by the firm which administers her 457 plan and with her limited investment choices and she is disappointed that her 457 pension cannot be converted to a Roth IRA or used to fund her estate plan and that there will be nothing left if she dies prematurely.

Alice was therefore delighted to learn that the 2001 Act allows her to take distributions according to the same minimum distribution rules as allowed IRAs and other pensions. Even better, she discovered that the 2001 Act allows her to roll her account over to an IRA where she will have more investment options.

---

[71] Conference Committee report, pp. 248 - 252. Employer plans need not accept transfers.

[72] IRC §457(d)

[73] The 2001 Act changes federal law so that the distribution options available to 457 plan participants are the same as for IRAs and other pensions.

Education Incentives

The 2001 Act allows contributions to an Education IRA to increase from $500 to $2,000 annually and makes qualified 529 plan distributions tax-free.

The 2001 Act also allows same beneficiary rollovers from one 529 plan to another. First cousins will be treated as a "member of the family" and this will make it possible for a grandparent to transfer 529 assets from one grandchild as beneficiary to another grandchild as beneficiary[74].

The 2001 Act also changes to the definition of qualified education expenses.

EXAMPLE. Joan established 529 plans for each of her grandchildren, Josh and Jennie. Josh completes school, leaving a sizable balance in his 529 plan, while Jennie opts for a medical residency and is forced into debt. Prior to the 2001 Act, Joan was unable to use the balance of Josh's 529 funds to assist his cousin Jennie. The money had to be distributed, and taxed.

The 2001 Act allows the transfer of 529 assets from one beneficiary to a first cousin as the new beneficiary. Joan transfers the leftover 529 funds in Josh's account for the benefit of her other grandchild.

New Tax Credit

Taxpayers who contribute to an IRA or make elective pension deferrals could be eligible for a non refundable federal tax credit[75].

Rough calculations suggest that a $2,000 per person IRA contribution might cost a single taxpayer with $17,000 in wages about $830, a head of household filer with $24,000 in wages about $550 and a married couple with $34,000 in wages about $720 each.

Few with such modest AGIs can afford professional services but the credit might apply to your customer's family members. Dependents, students and taxpayers under age 18 are not eligible.

The married couple with $34,000 in wages who increase their contribution from $1,000 to $2,000 per person will see their net tax liability decrease from $1,858 ($2,258 less $400 credit; see preceding table) to zero ($1,958 less $1,958 credit.) The extra $2,000 IRA contribution costs this couple $142.

---

[74] Joseph F. Hurley, *op. cit.*

[75] IRC §25B, added by the 2001 Act. AGIs of Joint, head of household and other returns cannot exceed $50,000, $37,500 and $25,000 respectively. The eligible contribution is reduced by any IRA or pension distribution prior to the due date for the current year's return or in either of the prior two tax years.

What Happens if Your State Does Not Conform?

The examples heretofore have assumed that the residency state has no income tax or that the state automatically conforms to changes in the Internal Revenue Code. If the residency state does not conform, it seems likely that[76]

- There will be a state tax liability on the "excess contribution" should an IRA or pension contribution be larger than permitted by current rules.

  There may be a state penalty on this excess contribution.

- Earnings on some excess contributions may be taxed currently.

  Qualified plans, 403(b) plans and governmental 457 plans are tax exempt trusts[77]. If your locality conforms to these provisions, earnings on excess contributions to one of these plans would be protected from current tax.

  California has a statute[78] which protects earnings on excess contributions to an IRA, SEP or SIMPLE plan from current tax and this protection may extend to Roth IRAs[79]. If your locality has a similar provision, earnings on excess IRA contributions would be protected from current tax.

- It is unclear whether there will be basis as a result of paying the tax on excess contributions or on the earnings on excess contributions[80]. Without basis, excess contributions and earnings would be taxed twice.

- Rollovers which are not permitted by current rules would be non qualifying distributions, meaning state tax and premature distribution penalties unless an exception is met. The rolled-over amount would be an excess contribution with possible current taxation of earnings and no basis.

- 529 plan rollovers and beneficiary changes would be non qualified distributions with immediate state tax consequences and penalties.

- The employer's payroll deduction would be limited on state returns.

---

[76] "Is Anybody in the State Legislature Listening? The Impact of Nonconformity on the California Economy" by Kathleen K. Wright, *State Tax Notes*, Tax Analysts, Washington, D.C., September 28, 2001.

[77] IRC §§501, 403(b)(1)(E) and 457(g)(2) respectively.

[78] CA Rev & TC 17507.

[79] The general rule embodied in §408A(a) is that a provision which applies to a traditional IRA also applies to a Roth IRA. "Except as provided in this section, a Roth IRA shall be treated for purposes of this title in the same manner as an individual retirement account." The opposing argument is one of legislative intent: did Rev & TC 17507 envision the possibility of Roth IRAs at the time of enactment?

[80] There is no statutory foundation for California basis in an excess contribution. Kathyleen Wright, *op. cit.*, opined that "It looks like the result will be that the monies contributed (in excess of $2,000) will be taxed again upon distribution." Her current view ("Compensation Planning for Individuals, Entrepreneurs and Small Businesses" sponsored by the California CPA Education Foundation, p. 7-23) is that excess contributions create state basis which will be recovered under the IRC §72 annuity rule.

My view is that an excess contribution does not create basis by analogy with 402(g)(7).

ALBERT REVISITED. Albert's new job is in California's Silicon Valley. The economy has sprung back strongly and Albert exercises incentive stock options with his new employer. Albert pays state income tax and a state premature distribution penalty on the IRA which he rolled into the qualified plan.

Come tax time, the extra state income tax means that Albert pays extra federal AMT.

ALICE REVISITED. Alice, the retired nurse with $200,000 in County Hospital's 457 plan, is shocked to discover that her state will assess $18,600 in income taxes if she transfers her 457 account to an IRA.

Even though Alice will pay state tax on the rollover, the rollover might be taxed again when distributed and she will be penalized if she forgets to file a Form 8606[81]. The good news is that her state defers the tax on earnings on an excess IRA contribution. Alice won't have to pay a premature distribution penalty because, fortuitously, the premature distribution penalty does not apply to 457 plans.

Given the state tax impacts, Alice does not roll her 457 account over to an IRA.

SEPs vs. 401(k) PLANS, REVISITED. We saw previously that SEPs are disadvantaged under the 2001 Act. The obvious conclusion was that a high earning self employed person should shift from a SEP to a 401(k) plan beginning in 2002.

The conclusion is less clear if the employee resides in a state which has not conformed to the 2001 Act. We again assume that the SEP plan does not permit deferrals.

	SEP federal	401(k) federal	SEP state	401(k) state
Percentage Limit	13%	20% plus deferral	13%	13%
Dollar Limit	$40,000	$40,000	$35,000	$35,000
Elective Deferral	None	$11,000	None	$10,500
Income				
$100,000	$13,000	$31,000	$13,000	$13,000
$150,000	$19,500	$40,000	$19,500	$19,500
$200,000	$26,000	$40,000	$22,100	$22,100
$250,000	$26,000	$40,000	$22,100	$22,100

Contributions in a non conforming state continue to be limited by the old rules with the result is that there is no difference in the contributions permitted SEP and 401(k) plans under state law. Further, there is no difference between SEP plans under the old rules or the 2001 Act so long as compensation does not exceed $170,000.

[81] In California, the rollover would probably be treated as a contribution to a nondeductible IRA. The non deductible IRA contribution is reported on a Form 8606 attached to the state return. While we may hope that "God works for my software provider," even a deity might be forgiven for failing to remember to file a Form 8608 with the state return when one is not required with the federal return.

The dilemma is whether to limit contributions to an existing SEP plan until there is state conformity and or to switch to the administratively more costly 401(k) plan, contribute more, and wrestle with state tax issues[82]. I bet that few will switch without conformity.

ABC CORPORATION, REVISITED. Paired money purchase/401(k) plans were merged into a single 401(k) plan for administrative convenience. As shown previously, contributions and deductions are unaffected for federal purposes under the 2001 Act.

Next year, annual additions for the firm's three employees will be as follows.

	Compensation	Elective Deferral	Employer 50% Match	10% Employer Contribution	Total Additions
John	$200,000	$11,000	$5,500	$20,000	$36,500
Judy	60,000	6,000	3,000	6,000	15,000
Jane	20,000	2,000	1,000	2,000	5,000
Total	$280,000	$19,000	$9,500	$28,000	$56,500

The state limits total additions to the smaller of 25% of compensation or $35,000, less than the new federal limits, because the state is continuing under the old rules. Each employee is limited to $10,500 in elective deferrals.

Total additions on Judy's behalf fall right at the 25% of compensation limit. Additions on John's behalf exceed the $35,000 limit and the excess contribution is imputed income on John's state W-2. John will pay state tax again on the excess deferral and perhaps on the entire the excess contribution when distributed. There would be additional imputed income if John or Judy opted for a "catch-up" contribution.

ABC Corporation's deduction for state purposes is limited[83] by 404(a) to $36,300 under the old rules and this limit includes elective deferrals. Actual additions are $56,500 which is more than the limit. $20,200 worth of payroll deductions are therefore disallowed on ABC Corporation's state income tax return.

[82] Excess contributions to a 401(k) plan are included in taxable income. Excess deferrals are taxed again when distributed. Other excess contributions might be taxed again when distributed. Earnings on excess contributions are probably tax deferred.

Excess contributions to a SEP are included in taxable income and might be taxed again when distributed. Earnings might be tax deferred.. (Earnings are tax-deferred in California, *vide supra*.)

[83] The state limits on the employer's deduction under IRC §404(a) and §404(j) are determined as follows.

	Compensation	Elective Deferral	404(a) Compensation	404(j) Limit
John	$200,000	$10,500	$170,000	$35,000
Judy	60,000	6,000	54,000	15,000
Jane	20,000	2,000	18,000	5,000
Total	$280,000	$18,500	$242,000	$55,000
Limit			0.15 * $242,000 = $36,300	$55,000

The 404(j) limit is the larger and therefore the employer's state deduction is limited by 404(a).

Had John's elective deferral been limited to $10,000, there would have been no extra W-2 income but $18,700 worth of payroll deductions would still have been disallowed on ABC Corporation's state income tax return.

Had ABC Corporation kept the paired plans while incorporating the new federal contribution limits and had John's elective deferral been limited to $10,000, ABC Corporation would have received a full deduction for pension expenses on both its federal and state returns and imputed income would have vanished from John's W-2.

EDUCATION INCENTIVES REVISITED. Joan transferred 529 funds left over from the education of one grandchild for the benefit of another grandchild. The transfer to a first cousin is a nonqualified distribution under state law - meaning tax and penalty - just as the pension rollovers were taxable events in the Albert and Alice examples.

Be aware that a same beneficiary rollover from one 529 plan to another could also be a nonqualified distribution under state law - meaning tax and penalty.

The good news is that any state tax or penalty would be one time events and that, going forward, earnings in the new 529 plan or in the 529 plan with the new beneficiary are likely to be deferred under existing state law.

The rollover from one 529 plan to another or from one grandchild to another could make sense even in a nonconforming locality so long as the tax and penalties are modest.

The 2001 Act allows contributions to an Education IRA to increase from $500 to $2,000 annually. Contributions of more than $500 will be "excess contributions" in a non conforming state with the potential for double taxation and the other difficulties discussed in the context of a traditional IRA.

The 2001 Act makes qualified distributions from 529 plans free of federal tax. This tilts the planning field towards 529 plans even if distributions are subject to state income tax.

Legislative Recommendations

In an ideal world, state income tax liability would be calculated as a fraction of the federal liability. This would simplify tax preparation and guarantee conformity. Those of us who do not live in such an ideal world must periodically convince our legislators to update local law.

Full conformity may not be in the cards given the other legislative priorities. Therefore, my recommendations are intended to be revenue neutral in the immediate term.

1. ~~Conform to increased contribution limits and catch-up deferrals.~~
2. Create state "basis" where needed to eliminate the double taxation of excess contributions and earnings.
3. Insure that earnings on excess contributions grow tax-deferred.
4. Allow employers to fully deduct pension contributions.

The example of ABC Corporation shows that permitting a full state deduction for pension contributions is unlikely to decrease state revenues because employers, at least small employers, are not going to change their pension plans if doing so means paying more state income tax.

5. Conform to the increased contribution limits on Education IRAs.

   No revenue is lost in the immediate future because contributions are not deductible for federal or state purposes.

6. ~~Exempt qualified 529 plan distributions from state income tax.~~

7. Conform to the rollover rules for pensions and education incentives.

   The Alice example illustrates that informed participants will not make pension rollovers if there is current state tax. Therefore, permitting rollovers does not affect state revenue.

8. Conform the definition of "member of family" for 529 plan asset transfers.

9. Insure that excess state contributions are not penalized.

10. Conform to the distribution options for 457 plans.

Acknowledgement. I am indebted to Kathleen K. Wright for sharing her ideas about California non conformity. The Albert and ABC Corporation examples were stimulated by her work. I am also indebted to David F. Crutcher for guidance concerning considered compensation.

8859 words