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QUALIFIED PLAN AND IRA TECHNICAL CORRECTIONS ENACTED IN THE CONSOLIDATED APPROPRIATIONS ACT OF 2001

[13068] January 23, 2001 TO: PENSION MEMBERS No. 4-01 PENSION OPERATIONS ADVISORY COMMITTEE No. 7-01 TRANSFER AGENT ADVISORY COMMITTEE No. 8-01 RE: QUALIFIED PLAN AND IRA TECHNICAL CORRECTIONS ENACTED IN THE CONSOLIDATED APPROPRIATIONS ACT OF 2001 As part of the Consolidated Appropriations Act of 2001, Congress passed various tax changes in the Community Renewal Tax Relief Act of 2000 ("the Act"). The technical corrections applicable to qualified plans and IRAs include the following: 1. Roth IRAs no longer subject to withholding rules. The Act amends section 3405 of the Code to exempt Roth IRAs from the tax withholding requirements. Section 3405 requires tax withholding on designated distributions from certain tax-favored arrangements, including IRAs. Section 3405(e)(1)(B)(ii) excludes from the definition of designated distribution the portion of any distribution that is reasonably believed to be excludable from gross income. All distributions from IRAs are considered to be includible in gross income, and therefore subject to the withholding rules. In order to account for the tax-free nature of certain Roth IRA distributions, the Act amended section 3405 to extend the exception to the withholding rules to Roth IRAs. The change is effective for tax years beginning after 1997. See Title III, Section 314(b) of the Act. 2. Nontaxable salary reduction amounts used for qualified transportation fringe benefits are compensation under qualified plan rules. Current law generally treats salary reduction amounts as compensation for purposes of the limits on contributions and benefits under qualified plans. An employer can elect whether or not to include such amounts for nondiscrimination testing purposes. Employers were recently allowed to offer a cash option in lieu of qualified transportation benefits. The Act treats salary reduction amounts used for qualified transportation benefits the same as other salary reduction amounts for purposes of defining compensation under the qualified plan rules. In particular, the Act amends sections 403(b)(3)(B) and 415(c)(3)(D)(ii) to clarify that for purposes of the 403(b) annuity rules or the section 415 limits, compensation includes amounts contributed or deferred under the following plans: (i) a section 125 cafeteria plan; (ii) a section 132(f)(4) qualified transportation fringe benefit plan, or (iii) a section 457 deferred compensation plan of a state or local government or a tax-exempt organization. 2The Act also amends section 414(s)(2) to provide that any definition of compensation based on section 415(c)(3) or that Code section reduced by certain items, satisfies section 414(s) even if it is modified to include all amounts contributed by the employer under a salary reduction agreement but excluded from gross income under: (i) section 125 cafeteria plans; (ii) section 132(f)(4) qualified transportation

fringe benefit plans; (iii) section 402(e)(3) cash or deferred arrangements; (iv) section 402(h) SEPs; or (v) section 403(b) tax-sheltered annuities. The changes are effective retroactively for tax years beginning after 1997. See title III, Section 314(e) of the Act. 3. Lump-sum distributions from a terminated 401(k) plan include distributions from annuity contracts. The Small Business Job Protection Act of 1996 moved the definition of lump- sum distribution from section 402(d)(4)(A) to section 402(e)(4)(D)(i) but without the following sentence: “A distribution of an annuity contract from a trust or annuity plan referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution.” The Act adds comparable language to the definition of lump-sum distribution in section 401(k)(10)(B), which permits certain distributions if made as a lump-sum distribution. Specifically, the Act defines a lump-sum distribution as a distribution of an annuity contract from either a qualified section 401(a) plan trust, which is tax-exempt under section 501(a), or a section 403(a) annuity plan. The Act applies retroactively for tax years beginning after 1996. See Title III Section 316(c) of the Act. 4. IRA contributions for a nonworking spouse cannot exceed a couple’s combined earned income. Prior to passage of the Act, in certain circumstances it was possible for a nonworking spouse (or the lesser earning spouse) to make IRA contributions in excess of the couple’s combined earned income. The Act provides that the contributions for the spouse with the lesser income cannot exceed the couple’s combined earned income. Specifically, the Act adds the following language to section 219(c)(1)(B)(ii): “the amount of any designated nondeductible contribution (as defined in Code section 408(o)) made on behalf of the spouse for the tax year.” The change is effective retroactively for tax years beginning after 1996. See Title III, Section 316(d) of the Act. 5. MSAs are extended 2 years. The Act extends the Medical Savings Account program through 2002. The same limits that apply for 1999 will apply for 2000 and 2001. Thus, the threshold level in those years is 750,000 taxpayers. In addition, the Act renames the program to Archer MSAs. See Title II, Sections 201 and 202 of the Act. A copy of the legislative language and explanatory language related to these provisions is attached. Kathryn A. Ricard Associate Counsel Attachments Note: Not all recipients receive the attachments. To obtain copies of the attachments to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachments for memo 13068. ICI Members may retrieve this memo and its attachments from ICINet (http://members.ici.org). 3Attachment no. 1 (in .pdf format)

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