Wisconsin Department of Revenue
Division of Research and Policy
January 23, 2003

INTERNAL REVENUE CODE UPDATE
LAWS ENACTED THROUGH DECEMBER 31, 2002

A. INTRODUCTION

The tax bases for Wisconsin's individual income and corporate income and franchise taxes closely conform to the bases for the federal individual and corporate income taxes. Conformity is achieved through references in Chapter 71 of the Wisconsin Statutes to the federal Internal Revenue Code. To maintain conformity, these references must be updated each year.

Federal laws enacted during 2002 include:

- Public Law 107-134, the Victims of Terrorism Tax Relief Act (VTTRA),
- Public Law 107-147, the Job Creation and Worker Assistance Act (JCWAA),
- Public Law 107-181, the Clergy Housing Allowance Clarification Act (CHACA),
- Public Law 107-210, the Trade Act,
- Public Law 107-276, which eliminated notification and return requirements for committees of political parties and candidates (this act has no substantive impact on Wisconsin), and
- Public Law 107-358, the Holocaust Restitution Tax Fairness Act (HRTFA).

Adoption of all these laws for Wisconsin tax purposes, effective at the same time they apply for federal purposes, is recommended, with two exceptions.

First, it is recommended that Wisconsin not adopt the 30% bonus depreciation provisions of JCWAA for property places in service from September 11, 2001, through September 10, 2004, because of the substantial fiscal impact of these provisions. Prior to enactment of 2001 Wisconsin Act 109, Wisconsin automatically adopted federal depreciation rules, but this act decoupled Wisconsin from the federal depreciation provisions in order to avoid a substantial revenue loss in the 2001-03 biennium. If Wisconsin chooses to adopt the bonus depreciation rules, the revenue loss would be $180 million in FY04 and $21 million in FY05.

Second, it is recommended that the deduction for teachers' classroom expenditures in JCWAA be adopted prospectively only. Retroactive adoption for tax year 2002 would require eligible taxpayers to file amended returns for a small tax benefit. The additional revenue loss that would occur if the deduction was adopted retroactively would be $1.4 million in FY04.

Table 1 shows the estimated impact of federal tax provisions with a non-minimal impact on Wisconsin tax revenues, not including the bonus depreciation provisions and the teachers' classroom deduction for 2002. These changes would reduce individual income and corporate income and franchise tax revenues by $2.05 million in FY04 and $1.05 million in FY05.

TABLE 1
FISCAL EFFECT OF ADOPTING FEDERAL TAX PROVISIONS

Federal Tax Change	Effective Date	Fiscal Effect ($ millions)	
		FY04	FY05
Individual income tax			
Deduction for teachers' classroom expenditures	1/1/02 (expires 12/31/03)	-$1.30	-$0.10
Expansion of exclusion for foster care payments	1/1/02	-0.50	-0.30
Corporate income and franchise tax			
Discharge of indebtedness of an S corporation	10/11/01	+0.40	+0.25
Limit of use of nonaccrual experience method of accounting	3/9/02	+0.25	+0.10
Qualified clean-fuel vehicle and refueling property deduction	1/1/02	-0.60	-0.30
Tax incentives for Indian reservations	3/9/02	-0.30	-0.70
Total		-$2.05	-$1.05

JCWAA also contained special depreciation and expensing provisions for investments in the Liberty Zone in New York, the area around the World Trade Center that was destroyed in the September 11, 2001, terrorist attacks. While Wisconsin taxpayers may be among the taxpayers making investments in that zone, it is expected that the fiscal effect on Wisconsin from these provisions will be minimal.

Changes to the IRC in 2002 that have a substantive effect on Wisconsin tax law, should they be adopted for state tax purposes, are summarized below. All provisions were in JCWAA, unless otherwise noted.

B. INDIVIDUAL INCOME TAX

1. Deduction for Teachers' Classroom Expenditures

Federal Change: For tax years 2002 and 2003, educators are permitted to deduct from gross income in the calculation of adjusted gross income up to $250 for unreimbursed expenses for books, supplies, computer equipment, and other equipment and materials purchased for use in the classroom. Educators who may claim this deduction include elementary and secondary school teachers, instructors, counselors, principals and aides. Under previous law, educators could only claim a miscellaneous itemized deduction for expenses in excess of 2% of adjusted gross income, a deduction that is not allowed for purposes of the Wisconsin itemized deductions credit.

Effective Date: For tax years beginning after December 31, 2001. It is recommended that this provision be adopted for Wisconsin purposes for tax years beginning after December 31, 2002. If it is adopted retroactively, eligible taxpayers would need to file amended returns for tax year 2002 to claim the deduction, but receive at most a $19 tax benefit, due to the $250 maximum deduction.

2. Expansion of Exclusion for Foster Care Payments

Federal Change: The exclusion for foster payments is expanded to include payments made by for-profit foster care placement agencies contracting with state and local governments. Previously, the exclusion was limited to payments from government and not-for-profit placement agencies.

Effective Date: Tax years beginning after December 31, 2001.

3. Tax Relief for Victims of Terrorism

Federal Change: VTTRA provides an income and estate tax relief for victims of the Oklahoma City terrorist attack in 1995, the attacks on September 11, 2001, and anthrax terrorism between September 11, 2001, and January 1, 2002. The relief is similar to that provided to military personnel killed in combat.

The act provides an income tax exemption for persons killed in these terrorist attacks for the year of death and the prior year. In addition, the act exempts from tax any death benefits paid by a victim's employer, excludes from income any cancelled mortgage or other debt and any disaster relief payments, and exempts the first $3 million of a victim's estate from state estate tax.

VTTRA also allows tax-exempt organizations that received donations to help victims of the September 11, 2001, attacks to make payments to the families of victims.

Effective Date: The exemption from income tax for victims of terrorism is effective for the year of the victim's death and the prior year. Other provisions are generally effective on September 11, 2001.

4. Extension of Archer Medical Savings Accounts

Federal Change: The Archer Medical Savings Account (MSA) program, scheduled to expire after December 31, 2002, is extended through December 31, 2003—after that date, no new MSAs may be set up, though existing accounts may be maintained.

Under the program, which requires enrollment in a high deductible health plan, employer contributions to an MSA are excluded from gross income and contributions by an individual may be deducted from income. Contributions are capped at 65% of the health insurance deductible for individuals and 75% of the deductible for family coverage. For individuals, the deductible must range from $1,550 to $2,350 and the maximum out-of-pocket limitation is $3,050. For families, the deductible must range from $3,100 to $4,650 and the maximum out-of-pocket limitation is $5,700.

Distributions from an MSA are excluded from income if they are expended for qualified medical expenses, including any unreimbursed medical costs for the benefit of an eligible MSA participant, his or her spouse and any dependent. Insurance may not be purchased with funds from an MSA, exception for long-term care insurance. Distributions used for purposes other than eligible expenses are subject to a 15% penalty unless the participant is 65 years or older.

The self-employed and employees of small employers (i.e., firms with 50 or fewer employees) may participate in the MSA program. For existing firms, the number of employees is the average number of employees over the previous two calendar years; for start-up firms, it is the average number of employees expected during the current year. Participating firms that grow beyond 50 employees may continue to enroll MSA participants until they have 200 employees; at that point, they may only maintain existing accounts. Further, the program is limited to 750,000 participants nationwide.

Effective Date: January 1, 2002.

5. Medical Expense Deduction Disallowed for Credit for Health Insurance Costs

Federal Change: The Trade Act provides a credit for health insurance costs of individuals receiving a trade readjustment allowance or benefit from the Pension Benefit Guaranty Corporation. The act provides that amounts for which a credit is provided may not be claimed as a deduction. By adopting this provision, amounts for which a credit is claimed would not be included as an expense eligible for the state itemized deductions credit.

Effective Date: Tax years beginning after December 31, 2001.

6. Repeal of Sunset for Victims of Nazi Persecution

Federal Change: HRTFA eliminates the sunset, for tax years beginning after December 31, 2010, for the exclusion from income for restitution provided to victims of Nazi persecution.

Effective Date: The exclusion continues for tax years beginning after December 31, 2010.

7. Principal Residence for Missing Children

Federal Change: Under federal law, a taxpayer may claim as a dependent a child presumed to be kidnapped by a nonrelative. The federal law change clarifies that a taxpayer who provided the principal abode for a dependent for purposes of the surviving spouse or head of household filing status in the year prior to the kidnapping continues to meet that principal abode requirement.

Effective Date: Tax years ending after December 21, 2000.

8. Rounding Rules for Adoption Credit and Exclusion

Federal Change: Rounding rules for the inflation adjustment for dollars limits and income limitations for the adoption credit and the exclusion for employer-provided adoption assistance are made uniform (amounts rounded to the nearest multiple of $10). Wisconsin allows the exclusion provided under federal law, but has no similar credit.

Effective Date: Tax years beginning after December 31, 2001.

9. Phaseout of the $25,000 Passive Loss Deduction for Rental Real Estate

Federal Change: Rental activities generally are considered passive activities, and losses from these activities cannot be used to offset salary, personal service compensation and other nonpassive income. However, a taxpayer who does not participate materially in a rental real estate business may deduct up to $25,000 of losses from this business, but this deduction is phased out as adjusted gross income rises from $100,000 to $150,000. JCWAA provided a technical clarification of the phase-out of this deduction when the taxpayer has a commercial revitalization deduction, low-income housing credit or rehabilitation credit.

Effective Date: December 21, 2000.

10. Election to Recognize Gain on Assets Held on January 1, 2001

Federal Change: JCWAA clarifies that gain on a principal residence from an election to treat an asset as having been sold and reacquired on January 1, 2001, is included in gross income. The $250,000 exclusion does not apply to the election.

Also a taxpayer making the election for an interest in a passive activity cannot take suspended losses because of the deemed disposition of the asset. Ordinarily, if during the tax year a taxpayer disposes of his or her entire interest in a passive activity, losses may first be taken against passive activity income and then against nonpassive activity income.

Effective Date: Tax years beginning after May 6, 1997

11. Additional 10% Tax on Taxable Distributions from Education Savings Accounts

Federal Change: The 10% additional tax imposed on taxable distributions from Coverdell education savings accounts does not apply to amounts used to claim Hope or Lifetime Learning credits. Wisconsin imposes a tax equal to 33% of the additional federal tax.

Effective Date: Tax years beginning after December 31, 2001.

12. Parsonage Allowance Exclusion

Federal Change: CHACA clarifies that the exclusion for a rental allowance provided to a member of the clergy is limited to the fair rental value of the home.

Effective Date: Taxable years beginning after December 31, 2001.

C. CORPORATE AND OTHER BUSINESS INCOME TAX PROVISIONS

1. Bonus Depreciation

Federal Change: A special 30% first-year bonus depreciation is allowed for certain property acquired after September 10, 2001 and before September 11, 2004. The bonus allowance must be taken in the year the property is placed in service and is in addition to the regular MACRS depreciation deduction and any allowable section 179 expense deduction.

Taxpayers may elect out of the bonus depreciation with respect to any class of property. Bonus depreciation is treated as depreciation for recapture purposes upon the sale of property. There is no taxable income limitation or investment limitation on the bonus allowance, as there is with section 179 property.

2001 Wisconsin Act 109 decoupled Wisconsin law from federal depreciation provisions. It is recommended that Wisconsin not adopt the bonus depreciation rules.

Effective Date: Property placed in service after September 10, 2001, in tax years ending after that date.

2. Bonus Depreciation for Liberty Zone Property

Federal Change: The 30% bonus first year depreciation allowance is available for qualified New York Liberty Zone property acquired on or after September 11, 2001. The liberty zone is located on or south of Canal Street, East Broadway, or Grand Street in the Borough of Manhattan.

Effective Date: March 9, 2002

3. Increase in Expensing for Liberty Zone Property

Federal Change: The section 179 expensing deduction is increased by an additional $35,000 for qualifying property in the Liberty Zone. As a result, the maximum section 179 expensing deduction is $59,000 in 2001 (for property purchased after September 10, 2001) and 2002, $60,000 thereafter for property placed in service in that tax year.

Effective Date: March 9, 2002

4. Five-Year Recovery Period for Liberty Zone Leasehold Improvements

Federal Change: Qualified New York Liberty Zone leasehold improvements placed in service after September 10, 2001 and before January 1, 2007 are depreciable over a five-year period rather than a 39-year period. Property that is eligible for the five-year depreciation is not also eligible for the 30% bonus depreciation.

Taxpayers may elect out of the bonus depreciation with respect to any class of property. Bonus depreciation is treated as depreciation for recapture purposes upon the sale of property. There is no taxable income limitation or investment limitation on the bonus allowance, as there is with section 179 property.

Effective Date: March 9, 2002.

5. Extension of Liberty Zone Property Replacement Period

Federal Change: The replacement period is extended from two to five years for property that was involuntarily converted in the New York Liberty Zone as a result of the September 11, 2001 attacks. Property is involuntarily converted when it is destroyed, stolen, condemned or disposed of under threat of condemnation and the taxpayer receives compensation for the property. Gain is generally not recognized for tax purposes if the owner buys qualified replacement property within two years.

Effective Date: March 9, 2002.

6. Discharge of Indebtedness of an S Corporation

Federal Change: JCWAA reverses a Supreme Court decision that allowed cancellation of indebtedness income to pass through to shareholders of an insolvent S corporation before it was used to reduce the S corporations tax attributes. The decision allowed the shareholders to increase their stock basis from cancellation of indebtedness income and then deduct suspended losses up to the amount of the increased stock basis. As a result of the JCWAA provision, income from the discharge of indebtedness that is excluded from an insolvent S corporation's income does not flow through to shareholders, increasing shareholder stock basis and allowing deductions for losses that shareholders did not incur economically.

Effective Date: Discharges of indebtedness after October 11, 2001, in any tax years ending after that date. The changes does not apply to discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

7. Securities Futures Contracts

Federal Change: The tax treatment of securities futures contracts is clarified so that terminations of contracts and sales and exchanges of contracts are treated in the same manner for determining gain or loss. The gain or loss from the termination of a securities futures contract has the same character as the gain or loss from the sale or exchange of the underlying property.

In addition, a clarification provides that the wash sale rules that apply to the closing of short sales of stock and securities and the holding period rules for short sales also apply to securities futures contracts to sell.

Effective Date: December 21, 2000.

8. Wash Sale Losses

Federal Change: A technical correction clarifies that wash sale rules do not apply to section 1256 contract losses. Section 1256 contracts are marked-to-market under daily cash flow systems and are traded on or subject to rules of certain domestic boards of trade. Generally, on the last business day of the year, section 1256 contracts are treated as if they were sold for fair market value, with resulting gains or losses attributable to that tax year.

Wash sale losses are those in which stock or securities are sold for a loss and the seller acquires substantially identical stock or securities within 30 days before or after the sale. No loss deduction is allowed for wash sales.

Effective Date: Tax years beginning after November 10, 1988.

9. Basis Reduction Rule Where Liabilities Assumed

Federal Change: The basis reduction rule of section 358 (h) is clarified so that only a liability that is assumed by another person as part of an exchange can result in a reduction of basis. The restrictions of section 358 (h) are intended to prevent acceleration or duplication of losses through assumption of liabilities. Generally, no gain or loss is recognized when property is transferred to a corporation in exchange for common stock if the persons transferring the property are in control of the corporation. When the corporation assumes liabilities with the property, the transferor's basis in the stock received is reduced by the amount of the liabilities, unless the assumed liabilities give rise to a deduction for the corporation.

Without the clarification, the basis reduction rule could be read as applying where the transferor receives stock with a basis in excess of its fair market value, which is subject to the assumed liability. The transferor could immediately sell the stock and recognize a loss and the corporation could deduct the amount of the assumed liability when it is incurred.

Effective Date: Assumptions of liability after October 18, 1999.

10. Limit of Use of Nonaccrual Experience Method of Accounting

Federal Change: The nonaccrual experience method of accounting is available only to service providers that meet a gross receipts test or are in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts or consulting. The method is also available if the service provider's annual gross receipts for all prior tax years are less than $5 million.

Under the nonaccrual experience method of accounting, service providers using the accrual method are not required to accrue portions of amounts that experience suggests will not be collected. The rule does not apply to interest or penalties for failure to timely pay.

Effective Date: Tax years ending after March 9, 2002.

11. Taxable REIT Subsidiaries

Federal Change: The definition of redetermined rents and redetermined deductions is clarified for purposes of the 100% excise tax on rents and deductions improperly allocated between a REIT (real estate investment trust) and its taxable subsidiaries.

The term "redetermined rents" is clarified to mean the excess of the amount treated as rents from real property by the REIT over the amount that would be treated as rents after a reallocation to clearly reflect income of services furnished by a taxable REIT subsidiary to a tenant of the trust.

The term "redetermined deductions" is clarified to mean the excess of the amount treated as deductions by the REIT over the amount that would be decreased on distribution to clearly reflect income between the subsidiary and the trust. There is a 100% excise tax in lieu of the reallocation.

Effective Date: Tax years beginning after December 31, 2000.

12. Sales of Partnership Interest with Appreciated Property

Federal Change: The JCWAA clarifies that upon the sale or exchange of a partnership interest, a transferor partner recognizes ordinary gain or loss on inventory, whether or not it has substantially appreciated (fair market value exceeding 120% of the adjusted basis). The Taxpayer Relief Act of 1997 failed to remove one statutory reference.

Effective Date: March 9, 2002.

13. Modified Endowment Contracts

Federal Change: JCWAA retroactively repeals a "clarifying" reference from the Community Renewal Tax Relief Act of 2000 (CRTRA) to the cash surrender value of the old contract when certain life insurance contracts are exchanged for a new life insurance contracts. The CRTRA added the word "old". The JCWAA deletes that word and goes back to prior language.

Effective Date: March 9, 2002

14. Qualified Clean-Fuel Vehicle and Refueling Property Deduction

Federal Change: JCWAA defers the phase-down of the clean-fuel vehicle property for two years, so that taxpayers who place clean fuel vehicles into service in 2002 and 2003 are entitled to the full deduction. The deduction is reduced by 25% for vehicles placed in service in 2004, by 50% for vehicles in 2005 and by 75% for vehicles in 2006. No deduction is available for clean fuel vehicles placed in service in 2007. JCWAA also extends the time period for exceptions to the depreciation deduction limits for electric vehicles and retrofit clean-fuel vehicles by two years, so that exceptions apply to property placed in service before 2007.

Clean burning fuel includes natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and other fuels when at least 85% of the fuel is methanol, ethanol, any other alcohol or any combination. The deduction is limited to $50,000 for any truck or van with a gross vehicle weight of 26,000 pounds or a bus with seating capacity of at least 20 adults. The deduction is limited to $5,000 for a truck or van with a gross vehicle weight rating greater than 10,000 pounds and is $2,000 for any other vehicle.

Effective Date: Property placed into service after December 31, 2001.

15. Taxable Income on Percentage Depletion

Federal Change: JCWAA extends the temporary suspension of the taxable income limit on the percentage depletion for marginal production to tax years 2002 and 2003.

Taxpayers may recover investments in oil and gas wells using depletion deductions. When percentage depletion deductions are used for certain properties, a specified percentage of the gross income from the property for the tax year is deducted. The deductions may not exceed 100% of the net income from the property for that year. Special rules apply to oil and gas production from marginal properties. A rule that provides that the 100% income limitation does not apply to domestic oil and gas

production from marginal properties would have expired for tax years in 2002, but was extended to 2004.

Because Wisconsin limits percentage depletion to pass-through entities such as S corporations, limited liability companies, and partnerships, and does not permit it for C corporations, the fiscal effect of this provision is expected to be minimal.

Effective Date: Tax years beginning after December 31, 2001.

16. Tax Incentives for Indian Reservations

Federal Change: Accelerated depreciation rules are extended to qualified property on Indian reservations. Qualified Indian reservation property must be used predominantly in the active conduct of a trade or business within a reservation, not regularly used or located outside the reservation, not acquired from a related person and not used for certain gaming purposes.

Effective Date: March 9, 2002

17. Subpart F Exemption for Active Financing

Federal Change: Active financing income exceptions under subpart F are modified and extended for five years. The temporary exceptions from subpart F foreign personal holding company income, foreign base company services income and insurance income for certain income derived from banking, finance or insurance apply to tax years that begin in 2002 through 2006, and to U.S. shareholders in any of those years. JCWAA amends the determination of a life insurance company's reserve in some situations to allow use of a foreign statement reserve.

Subpart F is intended to prevent tax avoidance and tax haven abuse by limiting the deferral of U.S. tax on foreign income by certain U.S. owners with 10% more ownership of controlled foreign corporations. Temporary exceptions from subpart F income for certain active financing income have been enacted.

Because Wisconsin does not follow the federal Subpart F treatment for corporations, the fiscal effect is expected to be minimal.

Effective Date: For tax years beginning after December 31, 2001.

D. PENSION PROVISIONS

1. Interest Rate Range for Additional Funding Requirements

Federal Change: Federal law imposes minimum and maximum funding requirements on defined benefit retirement plans to ensure that employers make minimum contributions to the plan. The interest rate used to calculate current liability must be within a permissible range calcuated as a percentage of the weighted average rate for 30-year Treasury securities during the four years prior to the beginning of the plan year. For plan years beginning after December 31, 2001, and before January 1, 2004, the permissible range is 90% to 120% of the weighted average securities rate, instead of 90% to 105% of this rate.

In addition, the interest rate used in determining the amount of unfunded vested benefits for variable rate premium purposes is increased from 85% to 100% of the interest rate on 30-year Treasuries securities for the month prior to the beginning of the plan year. This raises premiums paid to the federal Pension Benefit Guarantee Corporation, but has no impact on Wisconsin.

Effective Date: March 9, 2002.

2. Combination of Plans

Federal Change: The limit on combined contributions to a defined contribution plan and a defined benefit plan, equal to 25% of compensation paid to a participant, does not apply when only elective contributions are made to a defined contribution plan. Elective contributions include contributions to 401(k), SIMPLE 401(k), 403(b) and simplified employee pensions (SEPs), provided the contributions are not included in the employee's income.

Effective Date: Years beginning after December 31, 2001.

3. Catch-up Contributions

Federal Change: An individual who will reach the age of 50 by the end of a tax year is permitted to make catch-up contributions, that is, extra contributions beyond those permitted to younger persons, to IRA, 401(k) and other tax-sheltered retirement plans. Previously, catch-up contributions were permitted only after the taxpayer reached the age of 50.

Catch-up contributions to elective deferral plans do not have to be included in gross income, as long as the contributions do not exceed the maximum allowable for the tax year. In determining the maximum allowable, qualified retirement plans, 403(b) plans, SEPs and SIMPLE plans are all treated as one plan. Catch-up contributions made by eligible individuals are not subject to the usual limit imposed on 401(k) and other elective deferral plans, SEPs, 403(b) plans, SIMPLE IRAs, defined contribution plans and 457 plans.

A special rule allows increased catch-up contributions for employees covered by 457 plans offered by state and local governments who are age 50 or older during one or more of the last three tax years before the employee reaches normal retirement age. This special rule permits a contribution equal to the ceiling for 457 contributions (in 2002, $11,000 but no more than 100% of compensation) plus the catch-up that generally applies to other employees (in 2002, $1,000), if that amount exceeds the maximum contribution allowed under the general rule for the last three years before retirement. The maximum contribution under the general rule is the dollar limit for the year ($11,000 in 2002) plus the amount by which the limit in preceding years of participation exceeded deferrals for that year, but not more than $22,000.

To satisfy nondiscrimination requirements, plans must allow all eligible individuals to make the same election with regard to catch-up contributions. All plans of a single employer are to be aggregated in determining if any plan discriminates, though this aggregation rule is waived for a limited period during dispositions and acquisitions.

Effective Date: Years beginning after December 31, 2001.

4. Direct Rollovers of After-Tax Contributions

Federal Change: Provisions requiring a plan to permit direct rollovers of distributions of after-tax contributions are clarified to provide that that the recipient plan must be a qualified defined contribution benefit plan that agrees to separately account for the taxable and nontaxable portions of the distribution.

Effective Date: Distributions after December 31, 2001.

5. Rollover Characterization

Federal Change: Rollovers of partial interests in qualified plans to defined contribution plans or IRAs that include both pre-tax amounts and after-tax contributions will be characterized as coming first from pre-tax amounts, rather than on a pro-rata basis. This will allow a person taking a partial cash distribution from a plan to avoid a penalty on amounts attributable to after-tax contributions.

Effective Date: Distributions after December 31, 2001.

6. Cash-Outs

Federal Change: Federal law permits qualified retirement plans to “cash out” involuntarily any participant whose employment has been terminated by the plan sponsor if the present value of the participant’s plan benefit does not exceed $5,000. JCWAA clarifies that a qualified joint and survivor annuity or qualified preretirement survivor annuity can exclude a participant’s rollover contributions and earnings on them from the present value of the benefit in determining whether an involuntary cash-out is permitted.

Effective Date: Distributions after December 31, 2001.

7. Top-Heavy Rules

Federal Change: In determining whether a defined benefit or defined contribution plan is “top-heavy”, that is, providing a disproportionate share of benefits or contributions to key employees, distributions made after severance from employment are taken into account for only one year, rather than five years.

Effective Date: Years beginning after December 31, 2001.

8. Anti-Cutback Rules

Federal Change: Under anti-cutback rules, an otherwise qualified retirement plan loses its qualified status if an amendment to the plan decreases the accrued benefits of employees. An exception is provided for amendments that reduce benefits to the level that would have applied without regard to the increase in benefits mandated by the Economic Growth and Tax Relief Reconciliation Act of 2001.

Effective Date: June 7, 2001.

9. Plan Valuation Dates

Federal Change: Federal law permits the valuation of a defined benefit plan in the prior, rather than current, plan year if the plan is well-funded. JCWAA reduces the threshold percentage of plan assets to plan liabilities, from 125% to 100%, for a plan to be considered well-funded. However, the 125% threshold applies when a change in funding method is made to take advantage of a prior plan year valuation.

Effective Date: Plan years beginning after December 31, 2001.

10. Deemed IRAs

Federal Change: For purposes of deemed IRAs, the term "qualified employer plan" is clarified to include a 401(a) retirement plan, 403(a) annuity plan, 403(b) tax-sheltered annuity plan and 457(b) deferred compensation plan maintained by a governmental employer. A deemed IRA is an individual retirement account or annuity established under a qualified employer plan to which employees may make voluntary contributions; these accounts are treated as IRAs and subject to IRA rules.

Effective Date: Plan years beginning after December 31, 2002.

11. Simplified Employee Pension Deduction Limits

Federal Change: The maximum contribution to an employee's SEP is increased to 25%, from 15%, of the employees compensation, but not more than $40,000.

Effective Date: Years beginning after December 31, 2001.

12. Simplified Employee Pension Compensation Defined

Federal Change: JCWAA clarifies that deductions for 401(k) and other elective deferrals are not subject to any limit imposed on deductions to SEP plans. In addition, compensation for purposes of computing the allowable deduction to SEP plans is defined to include elective deferrals. These changes provide uniformity between SEPS and other types of qualified plans.

Effective Date: Years beginning after December 31, 2001.

13. Simplified Employee Pension Participation

Federal Change: The minimum amount of compensation used to determine participation in an SEP is increased to $450 from $300, and this higher amount will be used as the base for future inflation adjustments.

Effective Date: Years beginning after December 31, 2001.

14. ESOP Dividend Reinvestment and Indexing

Federal Change: The tax year in which a deduction is allowed for dividends paid, at the election of plan participants or their beneficiaries, to an ESOP and reinvested in qualified employer securities is clarified. The year the deduction is allowed is the later of the year in which the dividends are reinvested or the year in which the plan participant elects to have the dividend paid to the plan and reinvested. A further clarification provides that dividends paid to the plan and reinvested must be nonforfeitable in order to satisfy minimum vesting standards for the plan. Finally, provisions for indexing for cost-of-living adjustments the dollar amounts used to determine the proper period for distributions from an ESOP.

Effective Date: Tax years beginning after December 31, 2001.

15. Tax-Sheltered Annuity Plans

Federal Change: JCWAA clarifies that limits on the amounts that can be contributed to a tax-sheltered annuity are applied without regard to when the contributions become vested. The act also clarifies that contributions may be made for an employer for up to five years after retirement, based on compensation for the last year of service prior to retirement.

Effective Date: Years beginning after December 31, 2001.

16. Church Plan Provision

Federal Change: Special rules relating to years of service with related church organizations by ministers, lay employees and foreign missionaries that were inadvertently eliminated by EGTRRA are restored. Thus, all years of services with related organizations are treated as years with a single employer.

Effective Date: Years beginning after December 31, 2001.

17. Definition of Compensation for Eligible Deferred Compensation Plans

Federal Change: A technical correction conforms the definition of compensation used for applying the contribution limits to 457 deferred compensation plans to the definition used for defined compensation plans.

Effective Date: Tax years beginning after December 31, 2001.

DC:PW:skr
t:\rpt\dc\irc update Jan03.doc