

**DRAFT LETTER TO EMPLOYEES**

Date:

Dear CSU Employee

RE: **Tax Law Changes Affecting 401(k), 403(b) and 457 and plans**

We are pleased to announce that conforming legislation has been passed in California, which effectively brings the California state tax code into compliance with the Federal Tax code as amended by the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001. Passage of this legislation enables CSU employees to take advantage of the full scope of the tax provisions provided by EGTRRA, retroactive to EGTRRA's initial effective date of January 1, 2002. The Economic Growth and Tax Reconciliation Relief Act (EGTRRA) of 2001 (HR 1836), signed into law on June 7, 2001, makes major changes to the rules governing tax-qualified plans such as the California State University (CSU) Internal Revenue Code (IRC) §403(b) plan, and the State's Savings Plus Program IRC §401(k) and Deferred Compensation IRC §457 plans. Historically, these plans operated under different rules consistent with the governing IRC Sections. EGTRRA reduces the differences between these plans, makes the benefits more portable and allows employees to save more each year for retirement.

*This letter is intended to provide a summary of the new tax law changes. It is not intended to provide legal, or financial advice. If you have specific questions, you should consult with your tax advisor or financial planner.*

The following is a brief summary of key EGTRRA provisions related to retirement plans available to eligible CSU employees.

**1. Elective Deferral Limits Increased**

The Internal Revenue Code (IRC) establishes specific limits that govern the amounts an individual can contribute to pre-tax salary reduction retirement plans, such as a 403(b), 401(k), and 457 plans. Effective January 1, 2002, only two limits will apply: the IRC Section 402(g) "elective deferral limit" and the IRC Section 415 "percentage of compensation" limit. For 2002, the limits will increase as follows:

<u>Plan</u>	<u>Limit</u>
403(b), 401(k) and 457	100% of compensation, or maximum \$11,000 per year.

Additionally, contributions to a 457 plan will no longer have to be offset by contributions to a 403(b), or 401(k) plan. For example, for tax year 2002, a participant could elect to contribute up to \$11,000 to a 401(k), or 403(b) plan AND up to \$11,000 to a 457 plan, for a total contribution of up to \$22,000. The maximum elective deferral limit will increase incrementally over the next five years, as follows:

<u>Tax Year</u>	<u>Limit</u>
2002	\$11,000
2003	\$12,000
2004	\$13,000
2005	\$14,000
2006 or thereafter	\$15,000

For tax years beginning after December 31, 2006, the elective deferral limitation will be adjusted for inflation in \$500 increments.

## **2. 403(b) Plan Change**

The Maximum Exclusion Allowance (MEA), used to determine the maximum amount a participant can contribute to a 403(b) plan, has been eliminated and replaced with new contribution limits, similar to other conventional retirement plans. Alternatives A, B and C limits have been repealed. For tax years beginning after December 31, 2001, only two limits will apply to 403(b) participants: the 402(g) elective deferral limit (\$11,000 for 2002), and the overall IRC Section 415(c) “percentage of compensation limit (100% of compensation).

## **3. Additional Catch-up Contributions – 403(b), 401(k), 457 Plans**

Individuals who are age 50 and older (as of the end of the tax year) will be allowed to make additional contributions via salary reduction (elective deferral) to a 401(k), 403(b), or 457 plan. Under this provision, the additional amount of elective contributions that could be made by an eligible individual participating in such a plan would be the lesser of (1) the applicable dollar amount as described below, or (2) the participant's compensation for the year, reduced by any other elective deferrals for the year.

<u>Year</u>	<u>Catch-up Limit</u>
2002	\$1,000
2003	\$2,000
2004	\$3,000
2005	\$4,000
2006	\$5,000

In 2007, the limit would be indexed for inflation in \$500 increments. Catch-up contributions made under this provision would not be subject to other contribution limits and would not be taken into account in applying other contribution limits. In 2002, a participant can defer \$1,000 to a 403(b) or 401(k) plan and an additional \$1,000 to a governmental 457(b) plan. The age-50 catch-up amount is not coordinated between a governmental 457(b) plan and a 403(b) or 401(k) plan.

Please note: Previously, EGTRRA had a non-duplication rule preventing 457 plan participants from combining the IRC Section 414(v) “age-50” catch-up with the IRC Section 457(b) “times two elective deferral” catch-up during the last three years before retirement. In accordance with the Job Creation and Worker Assistance Act of 2002, this rule has been modified and 457 participants are now entitled to make catch-up contributions up to an amount equal to the greater of (i) the age-50 catch-up limit or (ii) the 3-year catch-up limit.

## **4. Tax Credit for Low-Income Contributors**

For 2002 through 2006, you may be eligible to claim a tax credit on your federal tax return based on your pretax elective contributions. Contributions to 403(b), 401(k), 457 plans, or to an Individual Retirement Account (IRA) qualify for the credit. The credit is a percentage of the first \$2,000 in annual contributions, with the applicable percentage depending on your adjusted gross income (AGI) and tax filing status. The credit is available for joint tax filers with AGIs up to \$50,000; single or married individuals filing separately with AGIs up to \$35,000; and head of household tax filers with AGIs up to \$37,500. Certain individuals, including full-time students, are not eligible. Please consult your tax or financial advisor for advice about calculating and claiming the credit.

## **5. Hardship Withdrawals For 403(b), 401(k) and 457 Plans**

In cases of extreme financial need participants may be permitted to access some or all of their elective deferrals. Previously, a participant who takes a hardship withdrawal under the “safe harbor” rules may

not make elective deferrals for 12 months. Under the new law, the suspension period is reduced to six months.

**6. Purchase of Service Credit**

Beginning in 2002, eligible employees participating in a 403(b) and/or 457 plan will be able to use accumulated funds to purchase past service credits, or to repurchase service credits previously forfeited in a governmental defined benefit plan, such as the CalPERS retirement system, effective for trustee-to-trustee transfers made after 2001. Please contact CalPERS, or consult with your tax or financial advisor to determine whether this option would be beneficial to your situation.

**7. Defined Benefit Plan Limit Increased – §IRC 415(b)**

IRC Section 415 places a dollar limit on the annual benefit an individual can receive from a tax-qualified pension plan, such as CalPERS. Previously, the maximum annual limit is generally the lesser of 100% of the high three-year average of compensation, or \$140,000 (for 2001). The dollar limit was reduced if pension benefits began before (or increased if benefits began after) the participant attained the Social Security retirement age of 65. EGTRRA increases the maximum pension benefit a retiree can receive under a defined benefit plan to \$160,000, and eliminates the 100% of compensation limit. The adjustment for benefit commencement before the Social Security retirement age is amended so that a reduction occurs if benefits start before age 62, and an increase occurs if benefits begin after age 65. The annual limit will be indexed for inflation in \$5,000 increments in subsequent years. CalPERS has adopted a "Replacement Benefits Plan," which will, to the extent allowed by federal and state law, replace any benefits that exceed IRC Section 415(b) limits.

**8. Compensation Limit Increased – IRC §401(a)(17)**

IRC Section 401(a)(17) caps the annual compensation that can be taken into account in determining contributions and benefits under tax-qualified plans. In 2001, the limit was \$170,000. EGTRRA increases the compensation cap to \$200,000 for years beginning after 2001, to be indexed for inflation in \$5,000 (instead of \$10,000) increments. However, CSU employees who first became members of CalPERS prior to July 1, 1996, are exempt from any compensation limit.

**9. Expanded Rollovers**

EGTRRA allows balances in 403(b), 401(k) and governmental 457(b) plans, and Individual Retirement Accounts (IRA) to be rolled into each other, as long as the plan permits such rollovers, and is able to separately account for plan assets. This means that individuals who change jobs may no longer need to leave dormant accounts with their previous employers. Additionally, surviving spouses can roll over distributions to a 401(a), 403(b), or governmental 457(b) plan in which the spouse participates. For distributions after 2001, the Internal Revenue Service is authorized to waive the 60-day rollover deadline in hardship cases, under certain circumstances.

EGTRRA contains a "sunset" provision, which means that in the event that no further legislation extends, or otherwise amends these provisions, effective 2010, the affected provisions will revert to current law.

If you would like additional information about the State's 401(k) or governmental 457 plans, please contact the Savings Plus Program at (866) 566-4777. You may also obtain information via the Department of Personnel Administrator's web page at <http://www.dpa.ca.gov>. For information on the CSU 403(b) plan, please contact (campus benefits representative) at \_\_\_\_\_.

Sincerely,  
Campus Benefits Representative