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ALERT

EMPLOYEE BENEFITS/EXECUTIVE COMPENSATION

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Recent Developments Affecting Employee Benefits and Executive Compensation for Employees of Tax–Exempt Organizations

Retirement Plans

401(k) Plans

On July 17, 2003, the IRS and the Treasury Department published proposed regulations that would comprehensively update the regulations governing Section 401(k)[1] plans to reflect legislative changes and incorporate, with some changes and clarifications, guidance issued by the IRS since the regulations were last revised in 1994. The new proposed regulations would be effective no sooner than the first plan year beginning 12 months after the publication of the final regulations in the Federal Register. Among the most significant changes and clarifications that would be made by the regulations are the following:

- **Participation in 401(k) plans by sole proprietors.** The proposed regulations would clarify that sole proprietors may participate in Section 401(k) plans under the same rules that apply to common-law employees. The existing regulations make the same statement about partners, but do not mention sole proprietors.

- **Prefunding of contributions.** Prefunded elective contributions and prefunded matching contributions are contributions made to a Section 401(k) plan in anticipation of future employee elective deferrals. In Notice 2002-48, the IRS indicated that it would not challenge the deductibility of prefunded elective contributions as long as the contributions were made during the taxable year for which the deduction was claimed. The proposed regulations would revoke Notice 2002-48 and provide (1) that amounts contributed in anticipation of an employee's elective deferrals or future performance of services (and in anticipation of an employer matching contribution on such future deferrals) cannot be taken into account under the nondiscrimination tests that apply to elective contributions and matching contributions (the "ADP" and "ACP" tests) and (2) that such contributions do not satisfy any plan requirement to provide elective or matching contributions, regardless of the year in which the prefunded contributions are actually made. The result of the proposed rule would be that prefunded contributions, if made, would be subject to discrimination testing under Section 401(a)(4) (the general discrimination rule for tax qualified retirement plans) and could result in the disqualification of the plan if Section 401(a)(4) is not satisfied.

- **Aggregation of ESOPs with nonESOPs.** The proposed regulations would revoke the requirement in the existing regulations that the ESOP and non-ESOP portions of a Section 401(k) plan be tested separately for compliance with the ADP and ACP tests, and likewise would permit ESOPs and non-ESOPs to be aggregated

[1] Unless otherwise indicated, all section references refer to sections of the Internal Revenue Code of 1986, as amended.

for testing purposes (as long as the other rules for permissive aggregation are satisfied). This change is designed to make ADP and ACP testing easier for Section 401(k) plans that use an ESOP as an option for investing in employer stock.

- **Distribution events.** Under the existing regulations, the only permissible distribution events for elective deferrals under a Section 401(k) plan are severance from employment, death, disability, and certain types of plan terminations, and, if the plan is a profit sharing or stock bonus plan, financial hardship and attainment of age 59½. Additionally, certain corrective distributions are permitted if the plan violates the ADP test or if a participant contributes in excess of the Section 402(g) or 415 limits. The proposed regulations would make the following changes and clarifications:

  - **Retirement.** The proposed regulations would eliminate "retirement" as a distribution event for elective deferrals because is not listed in the Internal Revenue Code as a permissible distribution event and it is subsumed by "severance from employment."

  - **Severance from employment.** The proposed regulations would clarify, consistent with Notice 2002-4 and General Counsel's Memorandum 39824, that a severance from employment does not occur if the employee's new employer maintains the Section 401(k) plan with respect to the employee, for example by assuming sponsorship of the plan or accepting a transfer of assets and liabilities with respect to the employee.

  - **Plan termination.** Under the existing regulations, termination of a Section 401(k) plan generally is not a permissible distribution event for elective deferrals if the employer maintains or establishes a defined contribution retirement plan following the termination, unless the plan is an ESOP or a Simplified Employee Pension ("SEP") plan. The proposed regulations would expand the types of plans that an employer may maintain or establish after terminating a Section 401(k) plan to include SIMPLE IRA, Section 403(b) tax-deferred annuity and Section 457 plans.

  - **Plan-to-plan transfers.** The proposed regulations would clarify that a transferor plan fails to comply with the distribution limitation on elective deferrals (and qualified matching contributions ("QMACs") and qualified nonelective contributions ("QNECs") taken into account under the ADP test) unless it reasonably concludes that the transferee plan provides for the restriction on distribution. The IRS intends that rules similar to those in Treas. Reg. § 1.401(a)(31)-1 would apply to determine the reasonableness of the conclusion. Treas. Reg. § 1.401(a)(31)-1 permits a transferee plan accepting a rollover to rely on the transferor plan's representation in a letter that the transferor plan is a tax-qualified plan; therefore, the proposed regulations would presumably allow a transferor plan to rely on a representation by the transferee plan that the transferee plan will comply with the distribution limitation on the transferred elective deferrals (and any transferred qualified matching contributions and QNECs taken into account by the transferor plan under the ADP test).

  - **Hardship distribution safe harbors.** Under the existing and proposed regulations, there are two basic requirements for a hardship distribution of elective deferrals: the participant must have an immediate and heavy financial need, and the distribution must be necessary to satisfy the need. The existing regulations provide a safe harbor for complying with each of these requirements. The proposed regulations would clarify that a plan need not use the safe harbor for both requirements.

- **Election procedures for elective deferrals.** The proposed regulations would clarify that, in order for a plan to qualify as a Section 401(k) plan, an employee must have an effective opportunity to elect to receive cash (in lieu of plan contributions) at least once during each plan year.

- **Contingent benefit rule.** Under the existing regulations, an employer may not make other benefits (other than a matching contribution) contingent on an employee's election to defer or not to defer compensation under a Section 401(k) plan. For example, subject to several

exceptions, an employer may not provide for additional deferred compensation under a nonqualified deferred compensation plan on account of the employee making or not making elective contributions. The proposed regulations would clarify that an employer does not impermissibly condition other benefits on a Section 401(k) election if the employer limits elective contributions to amounts that are available after the application of the employee's other withholding elections (*e.g.*, payroll deductions on account of a plan loan).

- **ADP/ACP testing.** The proposed regulations contain several modifications and clarifications regarding ADP and ACP testing that are significant.

  - **Restriction of bottom-up leveling for correction of ADP/ACP failures.** Some plans, in the event of an ADP or ACP test failure, use a correction method that targets QNECs to certain nonhighly compensated employees ("NHCEs") in order to minimize the aggregate amount of QNECs that the employer must contribute to the plan in order to pass the test(s). Targeted QNECs are helpful because providing a QNEC to a NHCE with low compensation has a greater impact on ADP and ACP test results than providing the same QNEC to a NHCE with higher compensation. The proposed regulations would restrict this form of correction by disregarding for purposes of the ADP and ACP tests any QNEC that is allocated to any NHCE to the extent that the QNEC (when expressed as a percentage of the NHCE's compensation) exceeds the greater of 5% of the NHCE's compensation or two times the plan's "representative contribution rate." The plan's representative contribution rate is the lowest contribution rate of any NHCE who is eligible to participate in the plan and either is employed on the last day of the plan year or is among a group of NHCEs that consists of half of all NHCEs for the plan year.

  - **Plan document requirements.** The proposed regulations would require that a Section 401(k) plan document must specify the ADP and ACP testing methods that it uses. The tests themselves may be incorporated by reference, but any options must be specified (*e.g.*, whether the current year testing method is to be used).

  - **Consistency requirements.** The proposed regulations would require a single ADP testing method and a single ACP testing method to be used for all Section 401(k) elective contribution arrangements (referred to as "cash or deferred arrangements" or "CODAs") within a single plan. For example, one CODA within the plan could not use the current year testing method if the other CODA(s) in the plan used the prior year testing method. Additionally, an employer would not be able to aggregate CODAs in separate plans that had different testing methods. Similar rules would apply for employee after-tax contributions and matching contributions. A plan could apply the current year testing method for ADP test purposes and the prior year testing method for ACP purposes, or vice versa, although it would limit the use of some correction methods.

  - **Restriction on use of elective deferrals for ACP testing.** The proposed regulations would prohibit elective contributions under a plan that is not subject to the ADP test (*i.e.*, a safe harbor plan or a Section 403(b) annuity plan) from being treated as contributions for purposes of satisfying the ACP test.

  - **Prior year testing.** Under existing guidance, a plan that uses the prior year testing method and experiences a "coverage change" affecting more than 10% of NHCEs must use a modified ADP test. The proposed regulations would treat a reclassification of a substantial group of employees that has the same effect as amending the plan as a "coverage change" for this purpose. Additionally, the proposed regulations would continue the rule announced in Notice 98-1 that QNECs and QMACs must be contributed to a plan that uses the prior year testing method no later than the close of the plan year that is being tested. Since this rule limits the ability of the plan sponsor to use QNECs and QMACs as a correction technique, ADP testing failures may have to be corrected by actually limiting HCE deferrals during the year being tested or through the use of corrective distributions.

  - **Distribution of excess contributions/excess aggregate contributions.** The proposed regulations would *require* that income for the "gap period" (the period between the end of the plan year being tested and the date that excess elective contributions and excess aggregate contributions are distributed in order to correct an ADP or ACP test failure) be allocated to the distributions if the plan will credit the participant's account with income on the contributions during that

period. Under the existing regulations, the allocation of "gap period" income is optional.

- **Recharacterization of excess contributions.** A failure to satisfy the ADP test can be corrected by recharacterizing the elective contributions as after-tax employee contributions. The proposed regulations would change the tax year in which the employee must include the recharacterized contributions in income from the tax year that the contributions were made to the tax year they would have been included in income if they had been distributed, instead. Thus, excess contributions that are recharacterized more than 2½ months after the end of a year and recharacterized excess contributions that are less than $100 generally would be included in the employee's gross income in the year they are recharacterized rather than in the prior year.

- **Special rules for HCEs who participate in more than one plan**. The proposed regulations would clarify the application of the ADP and ACP tests to HCEs who participate in more than one Section 401(k) plan of the same employer.

■ **Safe harbor plans.** The proposed regulations would clarify several safe harbor design and operational issues:

- **Use of two plans to satisfy the safe harbor.** The proposed regulations would provide that, in the case of safe harbor matching or nonelective contributions that are made to a separate plan than the Section 401(k) plan, there is no requirement that the other plan be one that could be aggregated with the Section 401(k) plan under the discrimination rules. Thus, for example, it could include an ESOP.

- **Exclusion of employees from safe harbor contributions.** The proposed regulations would require a safe harbor plan to provide safe harbor matching or nonelective contributions to employees who are eligible to participate in the Section 401(k) component of the plan but who do not satisfy the minimum age and service requirements permitted under Section 410(a) (age 21 with one year of service), even if the portion of the plan covering those employees can satisfy the ADP test without taking advantage of the safe harbor rules. The proposed regulations would also provide that, to determine whether any HCE has a higher rate of matching contributions than any NHCE (prohibited under the ADP and ACP safe harbors), any NHCE who is eligible to participate in the Section 401(k) portion of the plan must be taken into account, even if the NHCE is not eligible for matching contributions.

- **Adoption rules.** The proposed regulations would clarify that a safe harbor plan generally must be adopted before the beginning of a plan year and maintained for a full 12-month plan year.

- **Suspension of employee after-tax contributions.** The proposed regulations contain no rules that restrict an employer's ability to suspend after-tax employee contributions to a plan that is designed to satisfy the ADP safe harbor through matching contributions. This would revoke the rule in Notice 2000-3 that restricts an employer's ability to suspend such contributions.

- **Special rules for HCEs who participate in more than one plan.** Notice 98-52 requires, in the case of an HCE who is eligible to participate in multiple Section 401(k) plans, that the HCE's contributions under all of the Section 401(k) plans be aggregated for purposes of determining whether the HCE had a higher matching rate than any NHCE who was eligible to participate in the safe harbor plan. The proposed regulations would not require such aggregation for purposes of the ADP safe harbor, but would retain the existing rule for purposes of the ACP safe harbor.

- **Anti-abuse rule.** In a departure from the mechanical approach to compliance taken in previous regulations, and perhaps in recognition of the fact that legislative changes since 1994 have tended to make testing more rather than less complicated, the proposed regulations would add an anti-abuse rule under which a plan will not be treated as satisfying the ADP test if there are repeated changes to plan testing procedures or plan provisions, and the principal purpose of the changes is to manipulate the testing rules to permit higher contributions by HCEs.

Catch-Up Contributions

On July 6, 2003, the IRS and the Treasury Department published final regulations under Section 414(v) that reflect

comments on the proposed regulations and statutory changes made by the Job Creation and Worker Assistance Act of 2002 ("JCWAA"). Section 414(v) was added by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), and became effective in 2002. It provides that a Section 403(b) tax-deferred annuity plan, a Section 401(k) plan, a Section 457(a) eligible deferred compensation plan maintained by a governmental entity, a SEP or a SIMPLE plan may permit participants who have attained age 50 by the end of the plan year and have made elective contributions up to the limits imposed by law and any other limits imposed by the plan to make additional "catch-up" contributions (up to $2,000 for most plans in 2003), generally without being subject to tax or causing the plan to violate any applicable nondiscrimination or other requirements. The right to make catch-up contributions must be made available to all eligible participants in all plans of the employer that permit elective contributions or the plans will be treated as violating the nondiscrimination requirements of Section 401(a)(4). This is known as the "universal availability" requirement. Since Section 401(a)(4) does not apply to Section 457(a) eligible deferred compensation plans, SEP or SIMPLE plans, the universal availability requirement does not apply to them. Among other things, the final regulations:

- Clarify that a participant who will reach age 50 before the end of a calendar year will be eligible for catch-up contributions beginning on January 1 of that year, regardless of whether the plan year is a calendar year.

- Prohibit catch-up contributions from being calculated on a payroll period-by-payroll period basis even if the plan imposes payroll period-based limits on contributions.

- Clarify, in the preamble, that limits imposed by a plan administrator in accordance with the terms of the plan but not actually required by the terms of the plan (such as limits imposed on elective contributions by HCEs when the plan administrator is concerned that the plan would otherwise fail the actual deferral percentage or "ADP" test) will be treated the same as other plan-imposed limits, and thus contributions in excess of such limits may be treated as catch-up contributions.

- Implement the exception from the universal availability requirement that was added by the JCWAA for plans acquired in connection with a merger or acquisition, and create additional exceptions from the universal availability requirement for collectively bargained employees and for Section 457(a) eligible deferred compensation plans of the same governmental employer.

- Implement the JCWAA's extension of Section 414(v) to the limit in Section 402(g) on total elective deferrals under all Section 403(b) tax-deferred annuity plans, Section 401(k) plans, SEP or SIMPLE plans in which an individual participates. (That limit is $12,000 in 2003.) This exception permits an employee who participates in plans of different employers to make additional elective contributions to one or more of the plans, up to the limit under Section 414(v), even if none of the plans treats the additional contributions as catch-up contributions.

- Implement the rule that was added by the JCWAA requiring all plans maintained by the same employer to be aggregated for purposes of applying the Section 414(v) limit.

Reversion Excise Tax

Section 4980 generally imposes a 50% excise tax on amounts that revert to an employer from a terminated defined benefit pension plan. However, the tax is reduced to 20% if the employer transfers 25% of the maximum amount of the reversion to another qualified plan covering the same employees. The amount transferred to the other plan is exempt from income tax. On July 1, 2003, the IRS issued Revenue Ruling 2003-85, which clarifies that the 25% requirement is a minimum only. Therefore, an employer that wants to transfer more than 25% of the maximum amount of a reversion to another qualified plan may do so and still qualify for the 20% excise tax rate and avoid income tax on the entire amount transferred to the other plan. The excise tax does not apply to an employer that is tax-exempt and is not subject to UBIT.

Cash Balance Plans

A cash balance plan is a defined benefit pension plan under which benefits are based on allocations and earnings credited to a notional account that resembles an actual account under a defined contribution plan. Allocations to the notional account are typically a percentage of compensation.

A vigorous debate has been going on for years in the government and the courts over (1) whether cash balance plans by their very nature discriminate against older workers in viola-

tion of the Age Discrimination in Employment Act ("ADEA") and analogous provisions in ERISA, and (2) exactly how a cash balance plan satisfies the accrual requirements of the Internal Revenue Code and ERISA. The age discrimination issue occurs because a participant's accrued benefit under a defined benefit plan must be expressed as a life annuity commencing at normal retirement age, and, under a cash balance plan, because of the time value of money, the additional annuity payments that allocations and earnings credited to a participant's notional account will buy typically become smaller as the participant ages.

Two recent decisions support the view that cash balance plans have problems in both areas. In the first decision, *Cooper v. IBM Personal Pension Plan*, a federal district court held that IBM's cash balance plan violated ERISA's prohibition against age discrimination because the rate of increase of the annuity payments to which a participant would be entitled at normal retirement age decreased as the participant grew older. Since this is a feature of virtually all cash balance plans, the decision calls into question whether any cash balance plan can comply with ERISA. However, in a well-known decision several years ago that for unknown reasons was not cited by the court, *Eaton v. Onan Corp.*, another federal district court reached the opposite conclusion, so the issue cannot be considered settled.

In the second decision, *Berger v. Xerox Corp. Retirement Income Guarantee Plan*, the Seventh Circuit, in an opinion written by Judge Posner, held that Xerox Corporation's cash balance plan violated ERISA's accrual rules when it calculated participants' lump-sum distributions without including all interest that would accumulate if the distributions were delayed until they reached age 65. Since many cash balance plans do not include all projected interest credits in this calculation—in part because doing so would increase the risk of age discrimination and in part because it would result in large lump sums for younger participants—the decision calls into question the design of many cash balance plans. Other courts have reached a similar conclusion. The decision also is consistent with IRS views expressed in a 1996 notice, which the Seventh Circuit and other courts cited with approval, although it is not clear that the IRS still holds the same views.

Elimination of Optional Forms of Benefit

On July 8, 2003, to conform with the rules added by EGTRRA, the IRS and the Treasury Department published a proposed regulation that would remove, effective July 8, 2003, the requirement that a defined contribution plan participant be notified 90 days in advance of a plan amendment that eliminates an optional form of benefit payment when the plan provides for an equivalent lump-sum distribution payable at the same time.

Mutual Fund Fees

In Advisory Opinion 2003-09A, issued on June 25, 2003, the DOL concluded that the receipt by a directed trustee of an employee benefit plan of 12b-1 fees from mutual funds in connection with investments by the plan in the funds is not a prohibited transaction as long as the decision to invest in the funds is made by a plan fiduciary that is independent of the trustee or by participants in the plans. This conclusion is consistent with previous DOL guidance.

GUST Remedial Amendment Period Extended Again for Some Qualified Plan Sponsors.

On August 28, 2003, IRS informally released Revenue Procedure 2003-72 which gives some qualified plan sponsors additional time to restate their tax qualified retirement plans for GUST if they will be filing a determination letter request with IRS. Before this release, plan sponsors who used pre-approved forms for their plan documents or certified their intent to convert from an individually designed format to a pre-approved format generally had until September 30, 2003 to execute restated plan documents to bring their plans into compliance with legislation represented by the GUST acronym. Under Rev. Proc. 2003-72, plan sponsors that are subject to the September 30, 2003 deadline have four additional months to prepare their determination letter requests. If such a sponsor timely adopts a restated plan document on or before September 30, 2003, or pays IRS a $250 compliance fee, the sponsor will have until January 31, 2004 to file a determination letter request with IRS. Unlike prior extensions of the remedial amendment period, *this extension is available only to plan sponsors who actually file a determination letter request on or before January 31, 2004.*

The only real effect of this "extension" is that a determination letter request which is filed on or before January 31, 2004 will relate back to September 30, 2003 and be treated as filed on that date for purposes of extending the period for adopting any required plan amendments. In other words, if during the determination letter process, IRS requires the

plan sponsor to adopt additional plan amendments, the sponsor will have until the end of the 91st day after a favorable determination letter is issued to adopt those required amendments. If such a sponsor does not file a determination letter request for a plan before February 1, 2004, its remedial amendment period for that plan will generally expire on September 30, 2003.

Legislation

The House Ways and Means Committee and the Senate Finance Committee are both considering bills that would replace the interest rate on 30-year Treasury bonds that is used in determining required pension plan funding contributions and lump-sum distributions to participants with rates based on corporate bond rates. There is a good chance that some version of these provisions will be enacted this year.

Welfare Benefit Plans

Reimbursements for Non-Prescription Drugs

On September 3, 2003, the IRS issued Revenue Ruling 2003-102. The ruling states that non-prescription medicine and drugs can be provided on a pre-tax basis under an employer-sponsored health plan, including through a health care flexible spending account, under Section 105(b) unless they merely benefit the general health of the individual, even though the Code specifically prohibits the cost of non-prescription medicine and drugs from being deducted as a medical expense under Section 213. The ruling also states that non-prescription dietary supplements such as vitamins that merely benefit the general health of the individual cannot be provided on a pre-tax basis under an employer-sponsored health plan, but leaves open the possibility that they can be provided on a pre-tax basis if they do more than that, such as if they are needed to counteract a deficiency caused by some medical condition.

Employers have recognized for a long time that the law technically permits non-prescription medicine and drugs to be provided on a pre-tax basis, but have been reluctant to take this position because of resistance from the IRS. Of course, employers are not required to treat non-prescription medicines and drugs the same as prescription medicine and drugs as a result of the ruling, but they might wish to do so as a benefit to their employees. Also, they might be required to do so if their health plan documents do not limit medical expenses to amounts deductible under Section 213.

COBRA

On July 1, 2003, the IRS issued Revenue Ruling 2003-70. The ruling concludes that, when applying COBRA's 20-employee requirement to an employer, (1) the employees of a target company acquired in an asset sale need not be taken into account unless the employer is a successor employer (that is, the seller ceases to provide any health plan to any employee in connection with the acquisition, and the purchaser continues the business operations associated with the assets without interruption or substantial change), but (2) the employees of a target company acquired in a stock sale must be taken into account because the employer and the target company become a single employer as a result of the sale. The ruling is effective for stock sales that take effect on or after July 7, 2003.

The Trade Act of 2002 made a tax credit available to the following individuals to help them purchase health insurance: (1) individuals receiving benefits under the Trade Adjustment Assistance or Alternative Trade Adjustment Assistance program (generally individuals who lost their jobs due to the effects of international trade), and (2) individuals receiving benefits from the Pension Benefit Guaranty Corporation who are at least 55 years old. The credit is equal to 65% of the premiums for "qualified health insurance" for the individual and his or her family. "Qualified health insurance" includes COBRA coverage (unless the employer pays 50% or more of the premiums), and coverage under a state-qualified health plan (a plan that has sought and obtained "qualified" status from the state in which it operates). A plan generally does not have to take any action for participants to take advantage of this credit, unless it wants to become a state-qualified plan. However, in order to receive payments directly from the government, as premiums become due, the plan must follow certain procedures. On July 29, 2003, the IRS published two new guides—"Health Coverage Tax Credit: The August 1, 2003 Implementation," and "Health Coverage Tax Credit: The COBRA Early Payment Procedural Guide"—which explain those procedures.

Age Discrimination

On July 14, 2003, the EEOC published a proposed regulation that would clarify that a reduction in benefits or elimination of coverage under an employer-sponsored retiree health plan when a retiree becomes eligible for Medicare or a state-sponsored health plan does not violate ADEA. The

proposed regulation would reverse the EEOC's old policy (rescinded in 2001), which was based on the Third Circuit's decision in *Erie County Retirees Association v. County of Erie*.

Executive Compensation

Nonqualified Deferred Compensation Plans

On July 11, 2003, the IRS and the Treasury Department published final regulations under Section 457 that update the existing regulations to reflect legislation since the regulations were last revised in 1982, and provide guidance on a number of open issues. The contents of the proposed regulations were discussed in the August 2002 Employee Benefits/Executive Compensation Alert.

Section 457 imposes special restrictions on nonqualified deferred compensation provided by state and local governments and tax-exempt entities such as public charities and trade associations. Nonqualified deferred compensation is deferred compensation that is not provided under a tax-qualified plan such as a Section 401(k) or Section 403(b)annuity plan, and usually is limited to senior executives. Under Section 457, deferred compensation provided by a tax-exempt entity is subject to tax as soon as it vests, rather than when it is paid, unless it is paid under a plan that satisfies a number of requirements, including requirements that it be unfunded and that amounts deferred under the plan not exceed a specified dollar limit ($12,000 for 2003). Plans that satisfy these requirements are called "eligible deferred compensation plans."

Until recently, tax-exempt employers had little incentive to qualify their plans as eligible deferred compensation plans, because of the low limits on deferrals and the fact that the limits were reduced by elective deferrals to other plans, such as Section 401(k) and Section 403(b) tax-deferred annuity plans. Their main concern in designing deferred compensation arrangements for their executives was to delay vesting, and thus taxation, for the desired amount of time, or take advantage of various exceptions from Section 457, such as the exceptions for bona fide severance pay and for transfers of property subject to Section 83.

EGTRRA and JCWAA made eligible deferred compensation plans *much more useful* by, among other things, significantly increasing the deferral limits and eliminating the rule reducing the deferral limits by an employee's elective deferrals to other plans such as Section 401(k) and 403(b)annuity plans, and (in the case of governmental plans) providing for special catch-up contributions for employees age 50 or older.

Among the most significant changes and clarifications that are made by the regulations are the following:

- **Written plan required.** The regulations require an eligible deferred compensation plan to be in writing, and contain all material terms and conditions for benefits under the plan, including the definition of "normal retirement age". Many existing plan documents do not satisfy this requirement. It is not clear whether the IRS will take the same position it does with respect to tax-qualified plans, namely that any failure to follow the terms of a plan, no matter how trivial, violates the written plan requirement.

- **Deferral of unused leave permitted.** The regulations permit amounts payable when an employee terminates employment for unused sick and vacation leave to be deferred under an eligible deferred compensation plan, reversing the position previously taken by the IRS. However, it applies only if (1) the deferral agreement is made before the beginning of the month when the payments would be made and the participant is an employee in that month, or (2) the payments would be made before the participant terminates employment and the agreement is made before that time, making the rule somewhat impractical.

- **Use of early normal retirement ages restricted.** The usual deferral limits under Section 457 are increased in the last three years before normal retirement age to the lesser of (1) twice the applicable dollar amount or (2) the sum of the normal deferral limit for that year and any unused normal deferral limits for prior taxable years in which the individual was eligible to participate in the plan. The existing regulations allow a participant's normal retirement age for this purpose to be set at any age from the age when unreduced normal retirement benefits are available under the plan sponsor's basic retirement plan to age 70½. If no normal retirement age is specified in the plan, then the normal retirement age generally is age 65. The new regulations generally would permit a normal retirement age earlier than age 65 only if the plan sponsor maintains a defined benefit pension plan and makes unreduced retirement benefits available under that plan earlier than age 65.

- **Hardship distributions allowed to include amounts for penalties and taxes.** The regulations clarify that a hardship distribution may include amounts needed to pay applicable taxes and penalties on the distribution. The same rule has applied for years to hardship distributions from Section 401(k) plans.

- **Guidance provided on elimination of rule coordinating deferrals under different types of plans.** Effective in 2002, EGTRRA eliminated the rule that elective contributions under a Section 401(k) plan, a SEP, a SIMPLE plan or a Section 403(b) annuity must be counted against the individual limit on deferrals. The regulations clarify that participants cannot make up for prior year contributions what they were prevented from making solely because of the old coordination rule.

- **Catch-ups limited to same plan.** The regulations base catch-up contributions to a plan during the last three years before retirement solely on the amount of unused contribution limits under that plan, not under all plans in which the employee has participated.

- **Loans prohibited.** The regulations expressly prohibit loans from eligible deferred compensation plans maintained by tax-exempt (but not governmental) entities. Previously, the IRS had merely refused to issue rulings on plans that permitted loans.

- **Plan-to-plan transfers.** The final regulations allow plan-to-plan transfers in a wider variety of circumstances than the proposed regulations did, including in-service transfers between governmental plans of the same employer that do not involve all of the assets of the plan.

- **Relief for exceeding deferral limits expanded.** The regulations provide that an eligible deferred compensation plan that allows participants to defer more than the amounts permitted under Section 457 can avoid disqualification by distributing the excess deferrals by April 15 of the following year. The proposed regulations would have limited this rule to plans maintained by governmental employers.

- **Application of deferral limits to earnings clarified.** The regulations clarify that earnings on unvested deferrals, and increases in the present value of unvested deferrals due to the passage of time, are taken into account as additional deferrals for purposes of the limitations on deferrals when the deferrals to which they relate vest, but that any earnings on or increases in the present value of those deferrals after that date are ignored.

- **Guidance on taxation of earnings under ineligible plans.** Benefits under a plan that is not an eligible deferred compensation plan are subject to income tax as soon as the participant's rights to the benefits are no longer subject to a substantial risk of forfeiture, *i.e.*, vest. The regulations clarify that earnings on unvested deferrals are included in a participant's income when the deferrals vest, not when the deferrals and earnings thereon are paid or made available to the participant.

- **Options and other transfers of property made subject to Section 457 under certain circumstances.** Recently, a popular technique for delivering additional compensation to executives of tax-exempt entities has been to grant them options to purchase shares in mutual funds or other investments, often at a discount, or to promise to transfer such shares to them at a later date. Most employers have taken the position that the tax treatment of these arrangements is determined under Section 83 rather than Section 457, and under Section 83 the executive will be subject to tax only if and when he or she receives the shares.

  The regulations attack these arrangements, and other arrangements involving transfers of property, by providing that Section 457 will apply rather than Section 83 if, under the arrangement, the executive has a vested right to anything before the property is actually transferred. Thus, for example, if an executive receives a fully vested option, the value of the option on the date of grant will be subject to tax under Section 457. The regulations do not explain how an option should be valued for this purpose. Similarly, if a tax-exempt entity makes an unconditional promise to deliver certain property to an executive at some time in the future, the value of the property will be subject to tax on the date the promise was made.

  This rule also applies to split-dollar life insurance arrangements to the extent that they involve transfers of property. In the preamble to the final regulations on split-dollar arrangements published on September 17, 2003, the IRS and the Treasury Department state that this means that Section 457 applies to any split-dollar arrangement unless employer premium payments are treated as loans. Our conversations with the drafters indicate that they intended this statement to apply only

to split-dollar arrangements subject to the final regulations. It is not clear how the IRS intends to treat existing split-dollar arrangements that are not subject to the final split-dollar regulations. One possibility is that it will apply Section 457 to endorsement-type split-dollar arrangements, under which the employee does not take ownership of the policy until the roll-out date, but not to collateral assignment-type arrangements, under which the employee owns the policy from the beginning of the arrangement.

The regulations grandfather options with no ascertainable fair market value that were granted on or before May 8, 2002, but the grandfather rule does not apply to any other transfers of property.

The regulations generally are effective for taxable years beginning after December 31, 2001, the general effective date of EGTRRA. It is not clear to what extent plans operated in good faith compliance with existing law are allowed a grace period to come into compliance with the regulations. The preamble says that a plan will not fail to be an eligible deferred compensation plan for taxable years beginning after December 31, 2001, and before January 1, 2004, if it is operated in accordance with a reasonable, good faith interpretation of Section 457(b). However the regulations themselves limit this rule to compliance with requirements imposed by EGTRRA.

Parachute Payments

On August 1, 2003, the IRS and Treasury Department published final regulations interpreting Section 280G, dealing with excess parachute payments. The original proposed regulations interpreting Section 280G were published in 1989. New proposed regulations were published on February 20, 2002. Consistent with the 2002 proposed regulations, the final regulations treat tax-exempt entities as corporations and therefore subject payments they make to Section 280G. However, they exempt payments by tax-exempt entities that are subject to anti-inurement requirements, including entities described in Sections 501(c)(3) (churches, charities and schools), 501(c)(4) (civic leagues and social welfare organizations), and 501(c)(6) (trade associations), provided that they are tax-exempt both before and after the change in control. This broad exemption does not extend to payments by taxable affiliates of tax-exempt organizations.

Investment Control

On July 23, 2003, the IRS issued two revenue rulings, Revenue Ruling 2003-91 and Revenue Ruling 2003-92, that suggest it is closely scrutinizing investment-oriented insurance and annuity contracts that grant the owner substantial control over the assets that support the contract to determine whether the owner of the contract should be treated as the owner of the assets themselves (and any income they generate) for tax purposes, based on principles of beneficial ownership and constructive receipt. The rulings will have little direct impact on employee benefit programs, except those that actually involve purchases of investment-oriented insurance and annuity contracts for executives or other employees. However, taking into account recent legislative proposals to tax executives on interests in nonqualified deferred compensation plans that give them extensive control over the assets credited to their accounts, the rulings are reminders that aggressive plan designs could have adverse tax consequences for participants.

All Plans

Importance of Accurate SPDs

Several recent decisions illustrate the importance of describing the terms of a plan accurately to participants and beneficiaries. Two decisions dealt with the circumstances under which a participant or beneficiary may recover benefits based on language found in a summary plan description ("SPD") that conflicts with the terms of the plan itself. Most circuits have held that, in such a case, the language in the SPD controls, although generally only if the participant or beneficiary can show that he or she relied on the language to his or her detriment. In *Burke v. Kodak Retirement Income Plan*, the Second Circuit aligned itself with the majority of circuits and held that, for such a claim to succeed, the participant or beneficiary must show that he or she was "likely to have been harmed as a result of [the] deficient SPD." By contrast, in *Burstein v. Retirement Account Plan for Employees of Allegheny Health Education and Research Foundation*, the Third Circuit aligned itself with the Sixth Circuit and rejected any reliance requirement.

Another decision dealt with whether a participant or beneficiary may effectively recover benefits based on inaccurate statements by a plan fiduciary, on the theory that the statements violated the fiduciaries duties under ERISA. In *Horn v. Cendant Operations, Inc.*, the Tenth Circuit refused to dis-

miss a disabled employee's suit alleging that her employer breached its fiduciary duties under ERISA when it failed to disclose that a new long term disability plan contained an "actively at work" requirement. The court held that an ERISA fiduciary has a legal duty to disclose material facts to an employee, and concluded that the "actively at work" requirement was such a fact in that, if the employee had known about it, she might have returned to work and become eligible for benefits under the plan. The SPD for the plan disclosed the "actively at work" requirement, but it was not yet available at the time that the employee was deciding whether to return to work. The court's analysis is generally similar to that found in decisions from other circuits.

Employment Taxes

Stipends for Medical Residents

In *United States v. Mayo Foundation for Medical Education*, the federal district court for Minnesota concluded that stipends paid to Mayo Clinic medical residents qualified for the exception from FICA taxes for compensation paid to students for service performed in the employ of a school, college or university. The court rejected the IRS's position that stipends paid to medical residents do not qualify as a matter of law for the exception, and instead applied the facts-and-circumstances test adopted in *Minnesota v. Apfel*, a 1998 Eighth Circuit decision dealing with the parallel exception under the Social Security Act. The decision is particularly helpful in that it applied to a hospital that, unlike the one in *Apfel*, is not part of or affiliated with a university.

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