

Federal Update 2004-32

December 9, 2004

TO: NCTR Members

From: Cindie Moore

RE: Resources on Recent Issues Including Minimum Distribution Final Rules

I have posted as part of this memo several documents that outline recent regulatory issues affecting NCTR members. The documents were produced by law firm members of NCTR: Mary Beth Braitman, Ice Miller; Carol V. Calhoun, Calhoun Law Group; and David Levine, Groom Law Group.

Included are:

- An overview of the minimum distribution final regulations by Ms. Braitman
- A PowerPoint presentation by Ms. Calhoun and Mr. Levine provided at the NCTR Convention, which summarizes current issues
- An outline by Ms. Calhoun (issues below)
- An outline by Mr. Levine (issues below)

The issues in Ms. Calhoun's and Mr. Levine's outlines are:

By Ms. Calhoun –

-Department of Labor Regulations on Mandatory IRA Rollovers of Small Cash-outs (September 28, 2004)

-Deferral of Termination Pay

-Minimum Distribution Rules under Internal Revenue Code section 401(a)(9) (Treasury) (June 14, 2004)

-Department of Labor Guidance on Missing Participants in Terminating Defined Contribution Plans (Field Assistance Bulletin 2004-02 (September 30, 2004))

-Deemed IRAs (section 408(q))

By Mr. Levine –

- Servicemembers Civil Relief Act of 2003 Impacts Plan Loans
- Current EGTRRA Remedial Amendment Period Expanded
- Final IRS Minimum Distributions Rules Affect Annuity Payments and Contracts
- Expansion of Group Trusts for Governmental 457 Plans and Deemed IRAs
- Final IRS Rules on Deemed IRAs Resolve Some Concerns
- Model Amendments for Governmental 457(b) Plans Contain New Guidance
- Proposed DOL Regulations on USERRA
- DOL Adopts Safe Harbor Default IRA Rule and In-House Class Exemption

MEMORANDUM

TO: Cindie Moore
National Council on Teacher Retirement ("NCTR")

FROM: Ice Miller (Mary Beth Braitman, Terry A.M. Mumford, and Lisa Erb Harrison)

DATE: December 11, 2004

RE: 401(a)(9)/Minimum Distribution Final Regulations

As you are aware, final regulations were issued June 14, 2004 regarding minimum distributions for defined benefit plans and annuity contracts under Internal Revenue Code ("IRC") § 401(a)(9). See 26 CFR §1.401(a)(9)-6. These final regulations offer a great deal of relief to governmental plans as compared to prior proposed and temporary regulations. We believe the lobbying effort from various organizations, including NCTR, was highly effective. In this memo, we highlight those areas of improvement, as well as our observations about the regulations.

AREAS OF IMPROVEMENT IN THE FINAL REGULATIONS

Increasing Benefits

Under IRC § 401(a)(9), benefits must generally be non-increasing once the benefits commence. The temporary regulations had permitted increases based on increases in the cost of living, as determined under a CPI, increases due to plan amendments, pop-ups, and the return of employee contributions upon the employee's death.

The final regulations retained the exceptions provided in the temporary regulations and expanded the exceptions for increasing benefits by permitting cumulative COLAs, COLAs with an annual cap and a periodic catch-up, COLAs based on a modified CPI, increases based the salary of an active employee, as well as fixed rate (less than 5% annually) or variable rate increases that are unrelated to cost-of-living or salary increases. Treas. Reg. § 1.401(a)(9)-6, Q&A-14. Additionally, the final regulations permit a beneficiary to convert the survivor portion of a joint and survivor annuity into a single sum distribution at the employee's death. A plan may also provide a final payment upon the death of the employee that does not exceed the excess of the actuarial present value of the employee's accrued benefit (within the meaning of section 411(a)(7)) calculated as the annuity starting date using the applicable interest rate and the applicable mortality table under section 417(e) (or, if greater, the total amount of employee contributions) over the total of payments before the death of the employee.

The final regulations further permit an increase as a result of dividend payments or other payments that result from actuarial gains, but only if—

- (i) Actuarial gain is measured no less frequently than annually;

- (ii) The resulting dividend payments or other payments are either paid no later than the year following the year for which the actuarial experience is measured or paid in the same form as the payment of the annuity over the remaining period of the annuity (beginning no later than the year following the year for which the actuarial experience is measured);
- (iii) The actuarial gain taken into account is limited to actuarial gain from investment experience;
- (iv) The assumed interest used to calculate such actuarial gains is not less than 3 percent; and
- (v) The payments are not increasing by a constant percentage.

This expanded list of COLAs and other increases was an important result of comments submitted by governmental plans.

Plan Amendments

The plan amendment exception was (and remains) a very important aspect of the temporary and final regulations because of its impact on ad hoc COLAs and other ad hoc post-retirement increases. The plan amendment exception to the non-increasing benefits rule is very broad – none of the limits relating to specific COLA increases, annual fixed percentage increases, etc., apply to a benefit increase that results from a plan amendment. Treas. Reg. § 1.401(a)(9)-6, Q&A-14(a)(4). For example, we believe if a benefit commences and three years later the state legislature passes an ad hoc 10% COLA, that COLA meets the plan amendment exception, and there is no 401(a)(9) problem due to that benefit increase (even if it would not otherwise comply with the limits on regular COLA increases not made by a plan amendment).

Joint and Survivor Benefits

Under IRC § 401(a)(9), benefits must primarily benefit the participant as opposed to the participant's beneficiaries – this is called the minimum distribution incidental benefit ("MDIB") rule. All joint and survivor benefit to a spouse were treated by the temporary regulations as satisfying MDIB rules.

However, joint and survivor benefits to a non-spouse were subject to limitations based upon the age difference of the participant and the beneficiary. For example, a 100% joint and survivor benefit could not be provided, under the temporary regulations, to a nonspouse beneficiary if the beneficiary was more than 10 years younger than the employee. The final regulations permit more flexibility if a participant retires before age 70. In that case, the number of years between the age at retirement and age 70 is subtracted from the age difference between the participant and his beneficiary to determine whether an option is permissible. Treas. Reg. § 1.401(a)(9)-6, Q&A-2(c).

The final regulations also include a provision sought by governmental plans, often called a pop-up to a surviving spouse. In this situation if a participant names his/her children as beneficiaries and if the payments cease after the child reaches the age of majority, then the

benefits may be payable to the surviving spouse. Additional exceptions are provided for students and disabled children. Treas. Reg. § 1.401(a)(9)-6, Q&A-15.

Changes in the Form of Distribution

Additional flexibility was provided by the final regulations with regard to changing the form of benefits by both the employee and the survivor. Treas. Reg. § 1.401(a)(9)-6, Q&A-13. If the distribution is in the form of a period certain only annuity (no life contingency), an individual may be allowed to change the form prospectively at any time. Upon marriage, an employee may be allowed to change his/her form of benefit to a qualified joint and survivor annuity. At the time of retirement or plan termination, an employee or beneficiary may be allowed to change the form of benefit, regardless of the form of benefit, before the employee's actual retirement or plan termination. (Note: A governmental plan is not required to afford members this flexibility, but if it does so, the final regulations prevent the flexibility from causing a problem under 401(a)(9).)

In order to modify a stream of payments in the circumstances identified above, the following conditions must be satisfied:

- (1) The future payments under the modified stream satisfy section 401(a)(9) and this section (determined by treating the date of the change as a new annuity starting date and the actuarial present value of the remaining payments prior to modification as the entire interest of the participant);
- (2) For purposes of sections 415 and 417, the modification is treated as a new annuity starting date;
- (3) After taking into account the modification, the payment stream satisfies section 415 (determined at the original annuity starting date, using the interest rates and mortality tables applicable to such date); and
- (4) The end point of the period certain, if any, for any modified payment period is not later than the end point available under section 401(a)(9) to the employee at the original annuity starting date.

One of the other changes sought by some governmental plans was included in the final regulations – a survivor may be allowed to convert the survivor annuity into a lump sum upon the death of the employee. (Again, this is not required, it is simply permitted under the final regulations.)

REQUIRED BEGINNING DATE

For a member, the required beginning date is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires. After an employee's death before commencement of required distributions, non-spouse survivor benefits must generally be paid under either the 5-year rule (the entire interest must be distributed by the end of the calendar year containing the 5th anniversary of the

employee's death), or the life expectancy rule, where the benefits are paid over the life expectancy of the beneficiary, starting by December 31 of the calendar year following the calendar year of the employee's death. In the case of a surviving spouse, the benefit may be paid under the 5-year rule or the life expectancy rule, in which case the benefit commencement may be delayed to the end of the calendar year in which the employee would have reached age 70½. If the required distribution had already commenced to the member before death, the remaining benefit must be distributed at least as rapidly as under the distribution method to the member.

EFFECTIVE DATE

The final regulations are effective as of June 15, 2004, and apply to distributions in calendar years beginning on and after January 1, 2003.

TRANSITIONAL RELIEF FOR GOVERNMENTAL PLANS

Transitional relief is provided to all plans so that they may follow a good faith interpretation of Code Section 401(a)(9) until calendar year 2006 for governmental plans. This reasonable good faith standard extends to the end of the calendar year that contains the 90th day after the opening of the first legislative session of the legislative body with authority to amend the plan that begins on or after June 15, 2004, if such 90th day is later than December 31, 2005. Treas. Reg. § 1.401(a)(9), Q&A-17. Under the transitional provision, a good faith interpretation would include reliance on the 1987 proposed regulations, the 2001 proposed regulations, the 2002 proposed regulations, or the final regulations. Preamble, 69 FR 33292.

SPECIAL PROVISIONS FOR GOVERNMENTAL PLANS

The IRS has recognized the difficulty that state and local governments face in changing plan provisions due to state constitutional or statutory prohibitions on benefit reductions. Therefore, in addition to the transitional provisions available as described above, the final regulations grandfather certain governmental plan provisions in effect on April 17, 2002. Governmental plan distribution options in effect on April 17, 2002, "will not fail to satisfy section 401(a)(9) merely because the annuity payments do not satisfy the requirements of A-1 through A-15 of [1.401(a)(9)-6]." However, the grandfathered options must satisfy the statutory requirements of Code Section 401(a)(9), based on a "reasonable and good faith interpretation" of that section. Treas. Reg. § 1.401(a)(9)-6, Q&A-16. We think there is more latitude with regard to the grandfathering than with regard to the transitional rule, in that it does not appear that the IRS is placing the same emphasis on reliance on prior guidance with respect to the grandfathered options.

The grandfather provisions only apply so long as the benefit option remains unamended. Any amendment to a grandfathered benefit option, and any new benefit option must be in compliance with the final regulations subject to the transitional period. Preamble, 69 FR 33292.

COMPLIANCE STRATEGY

Beginning Date Strategy

Funds should undertake (or complete) a compliance effort with regard to the required beginning date (as outlined above) for member benefits and survivor benefits. The final regulations continue to be very clear on these points, and the grandfathering provisions do not apply to the required beginning date of benefits.

Conforming Options Identification Strategy

Funds should consider which of their benefit options satisfy the final regulations. In many cases, this could be virtually all options.

Grandfathered Benefit Option Compliance Strategy

Funds should consider whether they have benefit options that would need to be grandfathered as of April 17, 2002. If so, those benefits should be identified so they can be monitored to avoid future disqualifying changes.

Transitional Strategy

Funds should examine whether there are some nonconforming options that do not meet the final regulations and may not (or should not) be grandfathered. Those options could be transitioned to a conforming form by January 1, 2006 (or later depending on legislative sessions).



Federal Law Update

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October 12, 2004

Emerging 403(b) Rules

- Original 403(b) regulations date back to 50's and 60's
- IRS plans complete overhaul
 - Expected by end of 2004
 - Will be proposed for comment
 - Unlikely to be effective until finalized
- NCTR preliminary comments submitted 6/30/03

Key NCTR Issues

- Preserve “grandfather” for self-insured programs (Rev. Rul. 82-102)
- Clarify permissible sources of deferrals
 - Sick and vacation pay
 - Back pay
 - Severance
 - 5-year after termination rule
- Loans/plan terminations – permitted

Key NCTR Issues

- Document compliance – only minimal requirements
- “Operational” compliance – entire plan generally not at risk
- Incorporate transfer rules
 - Rev. Rul. 90-24 (403(b) to 403(b))
 - EGTRRA (403(b) to DB plan)

Default Rollovers

- Final DOL regulations on default rollovers to IRAs of distributions between \$1,000 to \$5,000
- Effective March 28, 2005
- Will default rollover rules apply to governmental plans? IRS and Treasury informally indicating yes
- Will governmental plans cease involuntary cashouts? Or redouble efforts to get consent?
- How will escheat laws apply?
- Will governmental plans follow the DOL safe harbors for default IRAs
 - Investments designed to preserve principal (e.g., MMFs)
 - State laws may be inconsistent with the regulations

IRS Focus:

Deferrals of Termination Pay

- Deferrals of termination pay is under IRS study – both to pension and welfare plans
- Some issues:
 - Elective versus nonelective (is it subject to salary reduction rules?)
 - Welfare plans – is it subject to 125? Constructive receipt?
 - Retirement plans – is it an impermissible constructive 401(k)? Is it subject to 402(g) limits if to 403(b) or 457(b)?
 - Is a plan taking nothing but termination pay qualified?
 - Constructive receipt rules regarding elections?
 - Does collectively bargained versus noncollectively bargained make a difference?
 - Does FICA apply? When?

Minimum Required Distributions

- Final 401(a)(9) rules for DB plans issued 6/15/04
- Issue: annuities must be “substantially nonincreasing”
 - Limited COLA exceptions at 1.401(a)(9)-6, Q&A-14
 - Some governmental DB plan COLAs do not comply
 - “Pop-ups” where annuity payments to retiree increase when contingent annuitant predeceases are okay
- Issue: MDIB rules limiting survivor percentage where beneficiary is not the spouse
- Grandfather of governmental plan distribution options as in effect on 4/17/02, so long as it satisfies a reasonable and good faith interpretation of 401(a)(9)
- Proposed legislative “fix” in PC II

Nonqualified Deferred Compensation Legislation

- American Jobs Creation Act of 2004 would restrict nonqualified deferred compensation, including elections, timing of distributions, investment options, among other things:
 - Effective January 1, 2005
 - 403(b) plans, 457(b) plans, and 415(m) plans excluded
 - 457(e)(12) plans meeting certain requirements excluded

Missing Participants

- Recent Department of Labor missing participant guidance

Other Recent IRS Guidance

- Rev. Rul. 2004-12 – distributions from separate rollover accounts permissible; do not have to terminate employment a second time
- Other guidance in the ruling:
 - MRD and 72(t) 10% excise tax rules of the receiving plan apply to subsequent distributions from the receiving plan
 - For example, will lose age 75 rule on a rollover from a 403(b) to a 401(k), will lose special IRA 72(t) exceptions on a rollover from an IRA to a 403(b)

Other Recent IRS Guidance

- Deemed IRA regulations - governmental entities can now apply to IRS to be nonbank custodians. Code Section 408(q)
- IRS has issued guidance on how to determine the taxable portion of a pension payment made to a nonresident alien or Puerto Rico resident. Rev. Proc. 2004-37
- Governmental 457(b) plans and deemed IRAs can now participate in group trusts (several PLRs had already so held for governmental 457(b) plans). Rev. Rul. 2004-67, updating Rev. Rul. 81-100
- EGTRRA remedial amendment period expanded to end of 2005 plan year. Rev. Proc. 2004-25

Other Recent IRS Guidance

- Rev. Rul. 2004-57 and Ann. 2004-52 address when a union-based 457 plan can still be a governmental plan
- Governmental employer must formally adopt the plan
- Guidance specifies minimum level of governmental employer involvement, disclosure to participants, and how the plan relates to other plans of the employer
- If the plan meets the requirements, the union will essentially be treated like a third party administrator

Other Recent IRS Guidance

- Employees of the union itself may not participate
- Announcement provides transition rules for nonconforming arrangements
 - Must cease contributions by 2005
 - Plan must be corrected or funds transferred to a compliant plan by 2006
- Issue: What about ERISA?

Recent IRS Guidance

- Rev. Proc. 2004-56 contains model language for a governmental 457(b) plan

Roth 401(k) and Roth 403(b)

- 1/1/2006

Proposed Federal Legislation

- Portman-Cardin II, H.R. 1776
- National Employee Savings and Trust Equity Guarantee Act (“NESTEG”), S. 2424
 - Would expand portability between plans
- 403(a) / 403(b) / 457 legislation may be reintroduced in the next Congress:

Impact of Pending Legislation on Purchase of Past Service Credit

<u>Issue</u>	<u>House Ways and Means Bill (H.R. 1776, July 18, 2003)</u>	<u>Senate Finance Bill (“NESTEG,” Sept. 17, 2003)</u>
Former employees	No provision	Permitted
Air time	No provision	Permitted
Tier changes/upgrades	Permitted	Permitted
Distribution restrictions	DB plan controls	DB plan controls
415(n) limits on “nonqualified service”	Do not apply to transfers	Do not apply to transfers
Transfer from non-governmental	No provision	Not permitted

Servicemember Legislation

- P.L. 108-189, Servicemembers Civil Relief Act
 - Plan loan interest limited to 6%, excess must be forgiven
 - Acceleration of principal forbidden
 - Notice by servicemember required
 - Waiver by servicemember permitted
- Not passed: Guardsmen and Reservists Financial Relief Act, H.R. 1779 / S. 2474
 - 72(t) 10% excise tax relief for distributions during call-up
 - Make-up IRA contributions permitted

Cases of Interest

- Recent cases on FICA taxation of teacher buy-out payments indicate a split within the 6th circuit:
 - Appoloni v. United States, D. Mich., No. 5:02-CV-176, 7/21/04) - subject to FICA, not payments in exchange for property
 - Klender v. U.S., No. 02-10082 (E.D. Mich. 8/2/2004) – not subject to FICA
- Earlier case in 8th Cir., North Dakota State University v. U.S., 255 F3d 599 (8th Cir. 2001), held not subject to FICA, but the IRS had nonacquiesced in that decision

Federal Law Update, 2003-2004

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I. Department of Labor Regulations on Mandatory IRA Rollovers of Small Cash-outs (September 28, 2004)

A. Issue:

1. Private Internal Revenue Code ("Code") section 401(a) plans may not provide for mandatory distribution of a separating participant's/beneficiary's account balance (or present value of the accrued benefit) if it is more than \$5,000 (the so-called "involuntary cash-out provision"). (Code Section. 411(a)(11).) Because this cash-out rule is part of the vesting and benefit accrual provisions that generally apply only to private plans subject to ERISA, governmental plans are not subject to this "involuntary cash-out provision;" they are free to make involuntary cash-outs of any amount, or not to provide for involuntary cash-outs at all.
2. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), P.L. 107-16, 6/7/2001, 115 Stat. 38, Sec. 657(a), added a provision to Code section 401(a)(31) requiring plans that include the involuntary cash-out provision to automatically roll over accounts between \$1,000 and \$5,000 into traditional IRAs, in the absence of another affirmative direction of the participant (the "mandatory rollover rule"). Unlike section 411, section 401(a)(31) applies to governmental plans. However, the mandatory rollover rule was not to become effective until DOL prescribed final regulations for plans subject to the ERISA fiduciary rules. (See Section IV below for the effective date discussion.)
3. Department of Labor ("DOL") published such final regulations on September 28, 2004. The DOL regulations outline safe harbor

fiduciary rules under the Employee Retirement Income Security Act of 1974 ("ERISA") for mandatory rollovers for small cash-outs. (ERISA Reg. § 2550.404a-2)

4. The Internal Revenue Service ("IRS"), in a footnote to the DOL regulations, stated as follows:

The Treasury and the IRS have advised the Department that the requirements of [the mandatory rollover rule] apply to a broad range of retirement plans including plans established under Code sections 401(a), 401(k), 403(a), 403(b) and 457.

(Preamble to ERISA Reg. § 2550.404a-2, fn. 7.) Based on this language, the rules would apply to governmental Code section 401(a) plans, Code section 403(a) plans, Code section 403(b) plans, and Code Sec. 457(b) plans. However, Treasury and the IRS have not issued any guidance themselves regarding how these rules would apply to governmental plans.

B. DOL Safe Harbor Rule

1. Applicability:

- a. The DOL safe harbor rule is only intended to protect plan fiduciaries from ERISA fiduciary liability for selecting an IRA provider and an initial IRA investment vehicle in connection with the mandatory rollover rule.
- b. However, the DOL rule may also be instructive to governmental plans in satisfying their own fiduciary obligations under state or other applicable laws, or in showing that a governmental plan has been operated in accordance with Code sections 401(a)(2) (exclusive benefit rule) and 503(b) (prohibited transaction rule).
- c. Moreover, these rules may also be important because IRA providers may be hesitant to allow regular IRAs to be used for small cash-outs even if the plan certifies that it is not subject to ERISA.

2. Under DOL's proposed regulations, a fiduciary is deemed to have satisfied his or her fiduciary duties under ERISA with respect to both the designation of an IRA provider and the initial investment choice for the IRA if the arrangement meets the following six requirements
 - a. Amount. The cash-out amount is more than \$1,000 but not more than \$5,000, excluding prior rollover contributions if the plan's involuntary cash-out provision so provides.
 - b. Type of Account. The mandatory cash-out must be directed to a traditional IRA (i.e., an individual retirement account under Code Sec. 408(a) or an individual retirement annuity under Code Sec. 408(b)).
 - c. Type of Investment. The proposed regulation would limit investments to investment products designed to preserve principal and provide a reasonable rate of return, whether or not this return is guaranteed, consistent with liquidity and taking into account the extent to which charges can be assessed against the account. DOL indicated that permissible investment products would include money market funds, interest-bearing savings accounts, certificates of deposits, and "stable value products" (including guaranteed investment contracts and similar investments). DOL expressly rejected the idea that the safe harbor should permit "mapping" the distribution into investment products identical or similar to those in which the participant had directed his or her investments prior to the mandatory rollover.
 - d. Permissible Fees and Expenses. The fees and expenses relating to the IRA may include set-up charges, maintenance fees, investment expenses, termination costs and surrender charges—subject to two limitations.
 - i. The fees and expenses relating to the "cash-out" IRA may not exceed the fees and expenses charged by the provider for comparable IRAs established for voluntary rollover distributions.

- ii. The fees and expenses (except for the set-up charges) may be charged to the IRA only to the extent of the income earned by the IRA. In other words, fees may not be charged against the IRA's principal.
- e. Disclosure. Before the mandatory cash-out, participants must be furnished with a summary plan description ("SPD") or a summary of material modifications ("SMM") that includes an explanation of the mandatory cash-out process. Because governmental plans are not required to have SPDs or SMMs, it appears they would be exempt from this requirement.
- f. No Prohibited Transaction. The fiduciary's selection of an IRA must not result in a non-exempt prohibited transaction.

3. IRS Amendment/Disclosure Issues

1. Plan Amendment: Section 401(a) plans (and presumably all non-ERISA plans) must be amended to include the mandatory rollover rule if the plan otherwise includes an involuntary cash-out provision. Will IRS issue model/sample plan language that will meet this requirement, and if so, will it cover the special situation of governmental plans?
2. Can a plan amendment that simply cross-references the Code provision that includes the mandatory rollover rule be sufficient?
3. Governmental plans should avoid incorporating the DOL regulations in the plan document (to avoid potential operational issues for failure to comply). At the same time, they may wish to add rules adapted to their own circumstances, to ensure compliance with the Code and applicable state fiduciary and prohibited transaction rules.
4. Timing of Plan Amendment: For 401(a) and 403(a) plans, a plan amendment generally must be made within the plan's remedial amendment period, which for this amendment is

the later of (1) the last day of the plan year when the law is effective, or (2) the due date (plus extensions) for filing the income tax return for the employer's tax year that includes the effective date of the law. In no event will the deadline be earlier than EGTRRA's remedial amendment period, currently the end of the 2005 plan year. However, the timing rules for 403(b) and 457 plans are less clear.

5. IRS Disclosure Rules:

- a. The Code (and legislative history) requires that the plan administrator (or payor for a 403(b) plan) revise the 402(f) notices (i.e., the statement that explains the right to roll over the distribution and the related tax consequences) to explain that an automatic direct rollover will be made for cash-outs over \$1,000 but not more than \$5,000, unless the participant elects otherwise. (Code Sec. 402(f)(1)) The current IRS model notice (Notice 2002-3) does not include this language. The plan administrator is also required to notify the participant in writing, as part of the 402(f) notice or separately, that the distribution may be transferred to another IRA. (Code Sec. 401(a)(31)(B)(i)) These disclosures will need to be provided for distributions made after the DOL safe harbor rule is "prescribed."
- b. For 403(b) plans, is it the "payor" who is responsible for the disclosures?
- c. What is the timing of the IRS disclosure rules if it is not contained in the 402(f) notice? Presumably, it would be the same as the 402(f) notice, which is generally 30-90 days before the distribution or the annuity starting date. What happens if there is a delay as a result of looking for missing participants?
- d. Will a summary 402(f) notice have to be revised for these new disclosure requirements?

- e. Presumably, the electronic delivery of the separate notice (if elected) would be permissible, in accordance with the current 402(f) electronic delivery provisions. Is there transition relief for distributions in process when the final regulations become effective; otherwise, all cash-outs pending as of the effective date may need to be given new disclosures and election timelines. A revised model 402(f) notice to reflect these new rules would be helpful.
6. Timing of Default Rollover: Is there a prescribed time frame within which the default rollover must be made? Current law does not prescribe a time frame for direct rollovers generally.
7. Use of Deemed IRAs: Can a plan sponsor use a deemed IRA as the designated default IRA, assuming they do not otherwise violate the Code's prohibited transaction rules (Code section 503(b)) that apply to governmental plans.
8. Under \$1,000: Can plans apply the mandatory rollover rule to cash-outs of less than \$1,000, or to accounts that fall below \$1,000 due to processing delays? Presumably the answer would be yes, although the DOL safe harbor may not apply.
9. Establishment of IRA: Will the IRS will modify the Form 5305 series (model IRA documents) to permit a plan administrator to establish an IRA on behalf of a participant in a manner similar to the use of a designated financial institution for SIMPLE IRAs? Another option would be to allow prototype IRAs to accept the mandatory rollover, though this may require filing for a new opinion letter for the IRA.
10. Determination Letter Procedure: The determination letter process is not yet open for EGTRRA changes. Therefore, 401(a) plans should not submit this amendment to IRS. However, a 403(b) or 457 plan may request a private letter ruling to confirm the mandatory rollover amendment. If IRS issues a sample/model plan amendment and it is timely adopted, it is unlikely that any further action would be

necessary for continued reliance on the plan's determination letter, advisory letter, or ruling.

11. **Effective Date:** What is the effective date for the mandatory rollover rule? Congress tied the effective date of the mandatory rollover rule to the DOL's prescription of final regulations. How does this apply to governmental plans, which are subject to IRS but not DOL regulations, and which have as yet received no guidance as to their specific situations?

12. **Cash-out of Beneficiaries and Alternate Payees:** Does the mandatory rollover rule apply to involuntary cash-outs of beneficiaries and alternate payees? Presumably, the rule would apply only to participants and alternate payees (but not to beneficiaries) with account balances or accrued benefits of \$5,000 or less, pursuant to the exception under the involuntary cash-out provision for payments after death. (Treas. Reg. § 1.411(a)-11(c)(5) and (c)(6).) However, the Code's references in the mandatory rollover rule to both "participant" and distributee," and the reference to "eligible rollover distribution" in the legislative history, make this unclear. For example, what happens if a participant dies but the plan sponsor is unaware of the death and rolls the money over to an IRA pursuant to the mandatory rollover rule? Can a surviving spouse beneficiary then treat the IRA as his or her own?

II. Deferral of Termination Pay

- A. Private Letter Ruling 200252095 (September 20, 2002) had allowed terminating employees to defer previously earned amounts payable only upon termination of employment pursuant to an election made 90 day before termination of employment.
- B. Regulations under Code section 457 have now prohibited deferral under section 457(b) of amounts payable only upon termination of employment.
- C. IRS is now studying issues involved in deferral of termination pay under both pension and welfare plans.

- D. Can Private Letter Ruling 200252095 be relied upon, with regard to taxpayers other than the one to whom it was issued? Can we expect a hardening of IRS position on pick-ups generally?

III. Minimum Distribution Rules under Internal Revenue Code section 401(a)(9) (Treasury) - June 14, 2004

A. Substance:

1. Apply to defined benefit plans and annuity products purchased with account balances in other types of qualified retirement plans and IRAs.
2. Payments must be either nonincreasing or increasing only as the regulations specify.
3. Examples of permitted increases in benefits:

. The following specific forms of benefit:

- . Single life annuity to the member with no survivor benefit
- i. Joint and survivor annuity where the spouse (other than a same-sex spouse) is the survivor (provided the survivor benefit is not greater than 100% of the member's benefit);
- ii. Joint and survivor annuity where the survivor is a non-spouse or a same-sex spouse and the age difference between the member and the survivor is no greater than 10 years (provided the survivor benefit is not greater than 100% of the member's benefit);
- iii. Annuities with period certain protection (provided certain restrictions on length of guaranteed period are not exceeded);

- a. COLA Changes if the increase is pursuant to
 - . Indexed benefits, if calculated under one of the following methods:
 - a. An annual percentage increase that does not exceed the annual percentage increase in a Bureau of Labor Statistics (BLS) general cost-of-living index or a cost-of-living index for a specific population or geographic area; or
 - b. A percentage adjustment based upon an increase in the compensation for the position held by the member at retirement.
 - i. Flat percentage increase that cannot exceed index: The final regulation allows for a percentage increase at a specified time (e.g. at specific ages). However, the increase may not exceed the cumulative permissible increase in the permissible index since the annuity start date or the date of the most recent previous percentage increase, if later.
 - ii. Flat Percentage Increase of Not Greater than 5% - In a later part, the final regulation also provides that, in the case of an annuity provided by a Code section 401(a) defined benefit plan, payments may be increased by a constant percentage applied not less frequently than annually at a rate not to exceed 5% per year.
- b. Increase Based on Actuarial Gain - In the case of an annuity provided by a Code section 401(a) defined benefit plan, an increase can permissibly result from dividend payments or other payments that result from actuarial gains but only if
 - . the actuarial gain is measured no less frequently than annually;

- i. the payment is either made no later than the year following the year in which the actuarial experience is measured or paid in the same form as the payment of the annuity over the remaining period of the annuity;
 - ii. the actuarial gain taken into account is limited to the actuarial gain from investment experience;
 - iii. the assumed interest used to calculate such actuarial gains is not less than 3%; and
 - iv. the payments are not increasing as a constant percentage.
- c. Changes based on changes in family circumstances, if based on one of the following:
- . An increase in a member's annuity to the extent that a reduction was necessary to provide a survivor benefit, if the survivor has died or is no longer the member's beneficiary pursuant to a qualified domestic relations order.
 - i. A pop-up in payments in the event of a divorce.
 - ii. A beneficiary's election to convert the survivor portion of the benefit to a lump sum.
 - iii. Subject to certain conditions, a "period certain only annuity" can be changed at any time.
 - iv. Subject to certain conditions, an annuity can be changed to a qualified joint and survivor annuity upon marriage in retirement.
 - v. Certain payments to "children" can be considered payments to the spouse for the purposes of the final regulation, provided the payments revert to the

spouse when "childhood" ceases. For these purposes, a disabled child is considered a "child" so long as the disability continues.

- vi. Ancillary benefits payable to a survivor upon the death of a member in retirement (provided the benefits are not part of the member's benefit being annuitized).
- vii. In the case of an annuity provided by a Code section 401(a) defined benefit plan, a final payment to a survivor that does not exceed the actuarial present value of the member's accrued benefit at the time of retirement over the total payments made before the death of the member (a "declining reserve annuity").

d. Increases in benefits pursuant to a plan amendment.

4. Examples of problematical increases in benefits:

- . Increases paid pursuant to COLAs/purchasing power protection provisions/thirteenth checks provisions not coming within any of the foregoing.
 - a. Joint and survivor annuities where the survivor is a non-spouse or same-sex spouse more than 10 years younger than the member, unless there are restrictions based on the life expectancies of the member and spouse.
 - b. Some period certain annuities, depending upon the age of the member at retirement.
 - c. Any form of survivor benefit which is greater than the benefit being paid prior to the member's death (unless the payment is permitted under one of the exceptions provided in the final regulation, e.g., a permitted COLA).

B. Effective dates

1. General effective date: June 15, 2004. For periods before June 15, 2004, Notice 2003-2 allows governmental defined benefit plans to satisfy "a reasonable and good faith interpretation" of Code section 401(a)(9).
2. Grandfathered benefits: Any "annuity distribution option" provided under the terms of a governmental defined benefit plan in effect as of April 17, 2002 will satisfy Code section 401(a)(9), provided "the distribution option satisfies [Code section 401(a)(9)] based on a reasonable and good faith interpretation of the provisions of [Code section 401(a)(9)]."
3. Temporary Relief for Non-Grandfathered Benefits (only allowed if the prior distribution method was justified by a reasonable and good faith interpretation of Code section 401(a)(9)).

- . All plans: With respect to any non-grandfathered distributions for calendar years 2003, 2004 and 2005, such distributions which do not satisfy the final regulation will be permissible provided "the distribution option satisfies [Code section 401(a)(9)] based on a reasonable and good faith interpretation of the provisions of [Code section 401(a)(9)]."

a. Governmental plans:

- . Benefits in the plan before April 15, 2002 and not amended thereafter: The temporary relief for distributions described in a. is extended "to the end of the calendar year that contains the 90th day after the opening of the first legislative session of the legislative body with the authority to amend the plan that begins on or after June 15, 2004, if such 90th day is later than December 31, 2005."
- i. Amendments adopted on or after April 17, 2002, but before June 15, 2002: These amendments do not receive the delayed effective date provided in paragraph (1). Moreover, if a benefit form was previously subject to the delayed effective date, the delayed effective date may be lost by amendments on or after April 17, 2002. However, forms of

benefit adopted or amended between April 17, 2002 and June 15, 2004 may still be applied to distributions before the end of 2005.

- ii. Post-June 14, 2004 Amendments - Any amendments made on or after June 15, 2004 must comply with the final regulation. Moreover, if amendments are made to grandfathered benefit forms, such amendments will cause loss of the delayed effective date described in (1).

IV. Department of Labor Guidance on Missing Participants in Terminating Defined Contribution Plans (Field Assistance Bulletin 2004-02 (September 30, 2004))

A. Applicability

1. In theory:

- . Does not apply to governmental plans, which are not subject to DOL regulation.
- a. Applies only to defined contribution plans, because defined benefit plans have separate mechanism for dealing with missing participants under the Pension Benefit Guaranty Corporation.
- b. Applies to terminating plans, which are rare in the case of governmental plans.

2. In practice:

- . Standards are likely to be looked to in other contexts as a measure of what is "reasonable" in locating missing participants (*e.g.*, to make required minimum distributions).
- a. Because governmental plans are often not directly under control of the sponsoring employer, and may be quite separate from other plans that cover the same employee,

they are much more likely than private plans to have participants become "missing."

3. Substance

0. Search methods to be used in all instances:

- . Use certified mail.
- a. Check related plan records. (This may mean, for example, that a statewide retirement system must check with a locally managed health or 403(b) provider, or a different statewide plan, to determine whether their records show an updated address.)
- b. Check with designated plan beneficiary. This means that the plan must check not only with a beneficiary who is currently entitled to collect benefits, but one who has been designated under the plan as a contingent beneficiary and is entitled to no current benefits.
- c. Use a letter-forwarding service. Both the Internal Revenue Service (IRS) and the Social Security Administration (SSA) offer letter-forwarding services. Plan fiduciaries must choose one service and use it in attempting to locate a missing participant or beneficiary.

1. Other methods to be used if appropriate under normal fiduciary standards:

- . Individual Retirement Plan rollovers, into investment products that are designed to preserve principal.
- a. Federally insured bank accounts.
- b. Escheat to state unclaimed property funds.

2. Impermissible options

- . 100% income tax withholding. Although some plan fiduciaries have believed that this method would ensure that the distribution would indirectly be returned to the participant (because it would be credited against the participant's income tax obligation), this method was specifically disapproved.
- a. Assumption that the participant's original selection of investments should continue to be followed once the money was transferred to the IRA. For example, even if a participant had chosen to have 401(k) assets held in an aggressive stock fund, those assets might need to be transferred to an individual retirement account that held more conservative investments.

V. Deemed IRAs (section 408(q))

- A. Definition: A deemed IRA is an arrangement under which a qualified retirement plan offers to employees the ability to keep their Individual Retirement Account ("IRA") assets in the plan as a separate IRA account within the plan. The IRA portion of the plan is treated as a separate IRA, and is not subject to the normal rules governing qualified plans.
- B. Joint investment of assets between a qualified plan and a deemed IRA:
 - 1. The trust fund for a qualified plan can hold the deemed IRA assets.
 - 2. However, if the assets of a deemed IRA are held in the trust fund for a qualified plan, separate accounts must be maintained.
 - 3. Moreover, if either the IRA or the qualified plan fails to meet statutory requirements, both the qualified plan and the deemed IRA may lose their tax-favored status. By contrast, if the deemed IRA assets are held in trusts separate from those funding the qualified plan, a failure of the deemed IRA to meet statutory requirements will not jeopardize the tax-favored status of the qualified plan or vice versa. [Treas. Reg. § 1.408(q)-1. (July 22, 2004)] It may

therefore be wise, where commingling of assets is desirable, for the plan and each deemed IRA to have a separate trust, and for all the trusts then to participate in a group trust described in Rev. Rul. 2004-67, 2004-28 I.R.B. 28, which is not subject to disqualification if one of the participating entities loses its tax-favored status.

C. Special rules for governmental deemed IRAs

1. Although normally the custodian of an IRA must be a bank or other approved entity, Temp. Treas. Reg. § 1.408-2(e)(8)T provides that a governmental unit is an acceptable trustee of a deemed IRA.
2. The IRS may exempt a governmental unit from certain other requirements upon a showing that the governmental unit is able to administer the deemed IRAs in the best interest of the participants. And IRS may apply the other requirements in a manner that is consistent with the applicant's status as a governmental unit.

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Servicemembers Civil Relief Act of 2003 Impacts Plan Loans

The "Servicemembers Civil Relief Act" ("SCRA"), signed into law by President Bush on December 19, 2003 (Pub. L. No. 108-189), is a comprehensive restatement of the Soldiers' and Sailors' Civil Relief Act of 1940 ("SSCRA") (50 U.S.C. App. 501 et seq.). This law is designed to protect the civil rights of active duty military personnel in both court proceedings and financial matters by suspending or postponing various civil obligations of a military service member. These protections apply whenever military service materially affects a service member's ability to fulfill a civil obligation. The SCRA, like the SSCRA, includes a provision that prohibits lenders from charging an active duty service member more than 6% interest on obligations or liabilities incurred before the date that active duty begins. (SCRA § 207.) However, the lender may seek relief in court to assert that the military servicemember is financially able to pay a higher rate of interest.

The SCRA clarifies the following aspects of the interest rate limitation.

- **Forgiveness of Excess Interest Required.** When the 6% interest limitation applies, a lender must forgive, and not simply postpone, interest in excess of 6 percent during the period of active duty. (SCRA § 207(a)(2).) This was assumed to be the requirement under the SSCRA based on legislative history, but was not explicitly stated in the statute.
- **Acceleration of Principal Prohibited.** A creditor is prohibited from accelerating the principal of an obligation by requiring that any periodic payment be reduced by the amount of interest forgiven. (SCRA § 207(a)(3).)
- **Servicemember Notice Required.** In order for the interest rate limitation to apply, the servicemember must give written notice to the creditor, along with a copy of his or her military orders, no later than 180 days after the date of the servicemember's termination or release from military. (SCRA § 207(b).) If this written notice is provided within this timeframe, the interest limitation is effective as of the date on which the servicemember is called to active service. An area not addressed is what the plan should do if the servicemember has already paid some interest at a rate in excess of 6% prior to the servicemember notifying the administrator of SCRA coverage. In that event, one possibility may be to recharacterize the excess interest as additional principal payments. There does not appear to be any IRS authority for returning such interest to the servicemember.
- **Waiver Permitted.** The servicemember also has the right to waive any of the protections under the SCRA. (SCRA § 107.) In the case of a plan loan, such a waiver would enable the servicemember to retain a higher rate of interest charged by the plan. This may be desirable to a participant in a defined contribution plan, since this will increase the amount that may be paid into the participant's account. To be effective, this waiver should be made pursuant to a written agreement between the plan and the servicemember.

The Employee Benefits Security Administration ("EBSA") of the Department of Labor had previously announced, under the sections of its website entitled "Frequently Asked Questions" and "Reservists Being Called to Active Duty" (http://www.dol.gov/ebsa/faqs/faq_911_2.html), that the SSCRA

6% interest limitation applies to plan loans. Presumably, this DOL guidance will be updated to reflect the SCRA provisions described above. According to the EBSA, a plan fiduciary could petition a court to retain a higher rate based upon the individual's ability to pay, but absent an order from the court, the plan fiduciary is obligated to reduce the interest rate to 6%.



Current EGTRRA Remedial Amendment Period Expanded

The IRS (in Rev. Proc. 2004-25, Apr. 19 IRS Bulletin) recently expanded the current EGTRRA remedial amendment period to cover nearly all plan amendments adopted after December 31, 2001, as well as new plans adopted after that date. Therefore, plan sponsors have until (at least) the end of the 2005 plan year to make retroactive plan amendments to correct "disqualifying provisions." Disqualifying provisions include a provision of a new plan, the absence of a provision from a new plan, or an amendment to an existing plan, that causes the plan to fail the section 401(a) qualification requirements. However, it does not extend the plan amendment deadline or 401(b) period for (1) good faith EGTRRA amendments, (2) GUST amendments, (3) minimum required distributions (§ 401(a)(9)) amendments, or (4) other IRS-required amendments (e.g., applicable mortality table, deemed section 125 compensation, retroactive annuity starting dates).

It is expected that plan sponsors will be able to apply for a single EGTRRA determination letter by the end of 2005 (or later, if extended), which will cover EGTRRA good faith amendments (and changes therein), new plans, voluntary plan amendments to existing plans, and miscellaneous IRS-required amendments. However, the IRS has not yet opened up its determination letter process for EGTRRA letters.

Final IRS Minimum Distributions Rules Affect Annuity Payments and Contracts

Treasury and IRS recently released the (hopefully) final installment of regulations interpreting the minimum required distribution rules ("MRD") for qualified, 403(b) and 457(b) plans, and IRAs. Treas. Reg. § 1.401(a)(9)-6, 69 Fed. Reg. 33288 (June 15, 2004). The final rules carry forward most of the rules contained in the comprehensive final MRD regulations published in April 2002 and (as IRS Notice 2003-2 indicated would be forthcoming) add a variety of complex new rules that primarily affect (1) annuity payments that may increase or change after payments commence (through COLAs and otherwise) and (2) how the MRD rules apply before annuity payments commence. These rules apply to defined benefit ("DB") plans and to defined contribution ("DC") plans that invest in annuity products or purchase annuities to make payments at retirement.

Much of the new additional guidance is provided in response to concerns expressed by annuity providers whose products include various new features and guarantees, and by the myriad distribution options permitted under governmental and other DB plans. However, other aspects of the new rules reflect Treasury and IRS' apparent concern that annuity products and DB plans may be structured to "backload" payments, and thus attempt to limit practices that violate the general requirement that MRD payments be "non-increasing." The end result appears to be that the MRD rules for DB plans are now more complex than the rules for DC plans (which the government did substantially simplify with the April 2002 final rules).

We summarize below the provisions in the new guidance likely to be of interest. We note that the only change to the MRD rules for DC plans is to allow separate accounts (i.e., accounts based on the life expectancy of each separate account beneficiary) to be established by the end of the calendar year following an employee's death (instead of by the end of the year of death).

MRD Compliance Before Annuity Starting Date – Before annuity payments begin, plans that hold annuities for participants who have reached their required beginning date ("RBD") must satisfy the MRD rules for DC plans. A key question has been what value to place on the annuity where the contract provides for a full refund of premiums, or enhanced death benefits or other benefit and/or investment guarantees. Rather than prescribing detailed guidance on how to value the additional features, the regulations provide a safe harbor that we suspect many contracts will fit. In essence, additional benefits may be ignored if their actuarial present value is no more than 20% of the dollar amount credited, and if withdrawals reduce the value of the additional benefits on a pro-rata basis. Also, an additional benefit in the form of a refund of premiums less amounts previously paid generally may be ignored.

Relaxed MDIB Rule For Non-Spouse Beneficiaries of Early Retirees – The MRD rules contain "minimum distribution incidental death benefit rules" compliance with which is deemed to satisfy the longstanding "incidental death benefit rule." These rules generally permit a 100% joint and survivor benefit where the contingent annuitant is the surviving spouse. However, the value of the survivor portion must be reduced for non-spouse contingent annuitants more than 10 years younger than the participant. The final rules make a modest adjustment to allow a longer survivor portion based on how many years before age 70 the annuity begins. For example, this change allows 100% continuation to a non-spouse beneficiary who is at least 30 years old where annuity payments commence to a 55-year old retiree. The earlier rules would have imposed a 66% maximum for the 30-year old beneficiary/55-year old retiree combination.

Permitted COLAs – Like the proposal, the final rules generally permit COLAs, but only if they are based on some form of BLS data (CPI-U). Such increases may be annual or cumulative, e.g., every 5 years or at certain designated ages. If the increases are not made annually, the actuarial value for the interim period must be ignored. In addition, a plan may provide for a fixed increase that is higher than the applicable COLA for a year, if the cumulative increases do not exceed what the cumulative COLAs would have been based on an approved index. (See below for other rules that allow certain fixed annual increases.)

Variable Annuities and Fixed Annual Increases – The final rules permit variable annuities, as well as certain fixed annual increases (not based on a COLA), if certain requirements are met. These rules apply to self-insured annuity payments under DB plans – as well as to annuity contracts purchased by DC plans and section 403(a) annuity plans (as under the April 2002 temporary rules). In some cases, self-insured annuities are subject to additional limitations, discussed below.

In general, the basic requirement is that the total future expected payments may not exceed the total value being annuitized. If this requirement is met –

- Payments may increase annually by a constant stated percentage (which must be less than 5% for a self-insured benefit).
- Insured annuity payments may be variable if adjustments are made at least annually, and gains are either paid out in the next year or are spread over the remaining expected payout period. They may also provide for fixed annual increases.
- Self-insured annuity payments must meet the above-described requirements, and (i) use an assumed interest rate of at least 3%, (ii) make adjustments solely based on investment experience, and (iii) may not also provide for fixed annual increases.

"Pop-Ups" and Accelerated Payments – The final rules contain additional liberalizations from the "non-increasing payment" requirement to recognize common practices in plans and annuity contracts. Specifically,

- annuity payments to retirees may increase ("pop up") when the contingent annuitant predeceases the retiree,
- a survivor may commute the value of the survivor annuity so as to receive a lump-sum as of the date of death,
- generally, any withdrawal or acceleration of payments from a commercial annuity (but not a self-insured one) is permitted – whether or not a total cash-out is permitted.

Change in Form of Distribution – The final rules address the question of when annuity distributions already in pay status may be changed. In general, so-called "reannuitization" is permitted if –

- the change occurs when the employee retires, the plan terminates, the payments were being made over a period certain without life contingencies, or the new payments are under a QJSA in connection with the employee's marriage,
- the future payments satisfy the MRD rules applied at the time of reannuitization,

- the period certain, if any, is no longer than would have been permitted when payments originally began, and
- the new annuity stream satisfies the section 415 benefit limitations and section 417 interest rate and mortality rules as of the new date (as well as satisfying the section 415 limits as of the original date, taking into account the modification).

Governmental Plan Transition and Grandfather Rules – Although the final rules allow much greater flexibility than the April 2002 proposal, the changes may not be adequate for governmental plans. For example, payment options under governmental plans often are reflected in state statutes and may be protected from diminishment by law. Accordingly, the final rules grandfather any "annuity distribution option provided under the terms of a governmental plan as in effect on April 17, 2002" as long as the plan satisfies a reasonable and good faith interpretation of Code section 401(a)(9). In this regard, government plans have been seeking legislation that would provide broader relief along these lines.

Effective Date/Plan Amendments – The final rules are generally effective for 2003 and later plan years, but strict compliance is not required before the 2006 plan year. In the meantime, DB plans must comply with "reasonable and good faith" interpretations of the MRD rules – which includes compliance with any of the previously issued proposed or final rules.

Rev. Proc. 2003-10 provides that DB plan amendments are not required until IRS announces the deadline. We expect that IRS may allow such amendments to be made within the time frame for final EGTRRA amendments (currently, the end of the 2005 plan year).

IRS Guidance on Withholding on Pension Payments Paid to Non-Resident Aliens and Puerto Rico Residents

After 25 years, the IRS has issued guidance on how to determine the taxable portion of a pension payment made to non-resident aliens ("NRAs") and Puerto Rico residents. This guidance, Revenue Procedure 2004-37 (June 9 IRS Bulletin), comes in the form of a safe harbor formula that can be used to determine the taxable portion of a payment from a qualified defined benefit plan ("DB plan"). In general, NRAs and Puerto Rico residents are only taxed on (1) investment earnings – because they are "sourced" to a domestic trust, and (2) employer contributions attributable to any services in the US. Rev. Rul. 79-388, 1979-2 C.B. 270. However, determining these taxable amounts under a DB plan is nearly impossible because:

- the benefit is based on the plan formula – either traditional or cash balance – rather than contributions and earnings in an account as in a defined contribution plan,
- contributions are made to the plan as a whole (not individual accounts) based on actuarial funding methods for the plan, with no relation to services performed by particular participants, and
- plans normally do not "track" investment earnings for such purposes.

Accordingly, in the past, plan sponsors have taken any number of approaches – from not reporting any amounts to treating all payments as taxable. Treas. Reg. § 1.861-4(b); but see Prop. Treas. Reg. 1.861-4(b)(2) (would replace the "facts and circumstances" test with a strict time-based allocation).

The IRS guidance ends this uncertainty by providing a rather complex formula – which takes into account the present value of the benefit, the years of participation in the plan, and the months of service credited under the plan that is attributable to services in the US and abroad – to determine the portion of the payment that is subject to US taxation and withholding. We understand that this guidance applies equally to NRAs who perform services both in the US and abroad, and to NRAs who perform all services abroad (so only the trust earnings are taxable to them), although the IRS release accompanying the guidance (and the examples in the Rev. Proc.) focus on dual employment situations.

Plan sponsors are not required to follow this new "safe harbor" approach, but the IRS will not issue private letter rulings on alternative approaches. Moreover, failure to follow this approach (or make a similar allocation) may result in reporting and withholding exposure, including penalties and interest, unless the payments are not subject to US tax at all because (1) tax treaty protection is available, or (2) the payments are made in the form of an annuity that satisfies Code section 871(f).

Expansion of Group Trusts for Governmental 457 Plans and Deemed IRAs

The IRS recently issued Revenue Ruling 2004-67 (June 23 IRS Bulletin), which officially expands the scope of group trusts under Revenue Ruling 81-100 to cover governmental 457(b) plans, which are deferred compensation plans of a state or political subdivision, agency, or instrumentality thereof. (The Service had previously issued several private letter rulings to this effect.) Accordingly, assets of eligible governmental plan trusts described in § 457(b) (which include a custodial account that is treated as a trust under § 457(g)(3)) can now be pooled in a group trust described in Rev. Rul. 81-100 – i.e., commingled with qualified 401(a) plan, traditional IRA, Roth IRA and deemed IRA assets – without affecting the tax status of either the governmental 457(b) plan or the group trust. The new guidance also confirms that Roth individual retirement accounts (Sec. 408A) and deemed IRAs (both traditional and Roth individual retirement accounts under section 408(q)) can participate in a group trust.

Rev. Rul. 2004-67 includes two model amendments that should be adopted by plans and trusts that wish to take advantage of the new guidance.

- **Amendment 1** – Amends the group trust to permit the acceptance of 457(b) funds. However, if the group trust document does not contain a provision for amendments to the group trust to automatically pass through to the underlying trusts/IRAs, the amendment is not available and the trust cannot continue to rely on the prior IRS determination letter.
- **Amendment 2** – Amends the 457(b) plan to permit investing its funds in a group trust. This amendment reflects the 5 basic requirements imposed on plans investing in group trusts under Rev. Rul. 81-100.

If these model amendments (or substantially similar ones) are adopted, the group trust and the 457(b) plan can continue to rely on favorable IRS letters issued prior to July 12, 2004, without filing for a new determination letter or letter ruling. This is true even if, as a result of the model amendments, it is necessary to delete a prior inconsistent provision under the group trust or 457(b) plan document.

Final IRS Rules on Deemed IRAs Resolve Some Concerns

Deemed IRAs, which became available last year, are a new design feature for qualified employer plans (401(a), 403(a), 403(b), and governmental 457(b) plans) that permit an employer to offer IRAs through its qualified plan. Employers can offer "one-stop" shopping for the employees' retirement needs, while potentially benefiting from lower costs due to the increased plan assets. Service providers also benefit from offering this feature by helping to capture the rollover market.

Despite these benefits, deemed IRAs have been slow-starters because proposed IRS regulations issued last year imposed the following administrative burdens/costs on establishing these accounts –

- **Separate Trust Requirement** – The proposed regulations required that a single trust (or separate trust for each participant) be established for the deemed IRA, using a bank or IRS-approved nonbank trustee/custodian. Separate accounting within a single trust that held both deemed IRA and qualified plan assets was not permitted.
- **Risk of Plan Disqualification** – The proposed regulations provided that the failure of "any" of the deemed IRAs maintained by the plan to satisfy the applicable requirements of section 408 or 408A would cause the entire plan to fail to satisfy the 401(a) qualification requirements. Conversely, if the qualified plan failed to meet such requirements, the deemed IRA also failed to qualify under Code section 408(q) (but could still qualify as a regular IRA, at least if the assets were not commingled in violation of Code section 408(a)(5)).
- **Governmental Employers** – Many governmental employers who wanted to establish deemed IRAs could not because state law prohibited them from using a bank as a trustee, and the governmental entities could not meet the IRS regulatory requirements for approval as nonbank IRA trustees, which were designed for private entities.

Treasury and the IRS address these concerns and others in just-released final, temporary and proposed regulations, which are more faithful to the "separateness" principles that Congress intended in creating the deemed IRA. 69 Fed. Reg. 43735 (July 22, 2004). However, there still appears to be a long way to go before deemed IRAs will appeal to many employers.

The final regulations, effective for deemed IRAs established on or after August 1, 2003, include the following changes/clarifications. In all other materials respects, they track the proposed regulations.

A. Some Barriers Removed

Separate Trust Requirement – A separate deemed IRA trust (or a separate trust for each participant) is no longer required for deemed IRA accounts. Separate accounting (for each deemed IRA and for the qualified employer plan) is sufficient, provided that the deemed IRA and qualified plan assets are held in the plan's trust. However, the preamble explains that the trust must have only one trustee, which is either a bank or an IRS-approved nonbank trustee. For deemed IRA annuities, the rules did not change – a separate (or group) annuity must still be established. Plan sponsors cannot simply combine deemed IRA assets with the plan's existing annuity contracts.

The regulations also clarify that deemed traditional IRAs and deemed Roth IRAs can be held in a single deemed IRA trust (presumably, along with qualified plan assets in the plan's trust), provided that

the trustee maintains separate accounts for the deemed traditional IRAs and the deemed Roth IRAs of each participant, and each of those accounts is clearly designated as such.

Risk of Plan Disqualification – The risk of disqualification varies depending on whether separate trusts are used to hold the deemed IRA assets and the qualified plan assets.

Separate Trusts/Separate Annuity Contracts: Any failure in the deemed IRA will not impact the tax qualification of the plan. The converse is also generally true. This is a very helpful change.

Separate Accounts/Single Trust: Any failure to meet the IRA requirements that causes the deemed IRA to be disqualified will also disqualify the plan and vice versa. Unfortunately, the IRS/Treasury failed to clarify what would disqualify the deemed IRA, other than investment in life insurance. However, it appears (based on the regular IRA rules) that only a prohibited transaction by the employee would trigger IRA/plan qualification issues (assuming that the deemed IRA was properly established) – as opposed to the IRA owner's failure to receive a minimum required distribution or making an excess contribution.

Governmental Employers – Temporary and proposed regulations provide for special IRS approval procedures for governmental units (i.e., State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State) that want to act as trustees for deemed IRAs as part of their governmental plans. 69 Fed. Reg. 43786. The governmental unit must demonstrate that it will administer the deemed IRA consistent with the requirements of Code section 408/408A. This demonstration must be made by written application to the Commissioner. The unit does not need to demonstrate that it meets all the requirements of Treasury Regulation 1.408-2(e)(2)-(6). For example, there is no net worth requirement, provided that the unit shows that it possesses taxing authority under applicable law. In addition, the Commissioner may (1) exempt the unit from certain other requirements upon a showing that it is able to administer the deemed IRAs in the best interest of the participants, or (2) apply the requirements in a manner consistent with the applicant's status as a governmental unit.

These special rules are applicable for written applications made on or after August 1, 2003, or such earlier application as the Commissioner deems appropriate. It is anticipated that governmental units that want to establish deemed IRAs will be able to do so. However, as noted, separate trusts must be maintained in order to avoid plan qualification risks.

B. Other Tax and ERISA Issues Clarified

1. Deemed IRA Participation

Automatic Enrollment – The preamble to the regulations clarifies that deemed IRAs offered as part of a 401(k), 403(b), or governmental 457 plan can use a "negative election" approach for deemed IRA contributions, along the lines that IRS has approved in the past for the affected plans.

Independent Contractor/Self-Employed – The regulations (and the preamble) clarify that, if a self-employed individual/independent contractor is an "employee" for purposes of the qualified employer plan, he or she can participate in the deemed IRA. For 401(a) and 403(a) plans, a self-employed individual that meets the definition of Code section 401(c) can participate in the deemed IRA. For a 403(b) plan, only a self-employed minister (as defined in § 414(e)(5)) who participates in a 403(b)(9) retirement account is treated as an employee. For a governmental 457 plan, employees and self-employed individuals are eligible to participate in the deemed IRA.

Different Eligibility Rules – The preamble to the regulations clarifies that deemed IRA and the qualified plan can have different eligibility requirements. Therefore, an employee can participate in the deemed IRA, without regard to whether or not the employee is participating or is otherwise eligible to participate in the qualified plan.

2. Administrative Issues

Incorporation by Reference – The preamble clarifies that the plan document may incorporate by reference the terms of a separate IRA agreement/annuity (rather than including the relevant IRA "Listing of Required Modifications" in the document), provided that the IRA document referenced complies with Code section 408(q) requirements (e.g., does not prohibit commingling of assets). Therefore, unless and until the IRS issues model deemed IRA forms, no incorporation by reference of Form 5305 series is permissible. However, plan sponsors may incorporate by reference a deemed IRA prototype document.

Reporting and Withholding – The preamble confirms that reporting and withholding rules apply separately depending on whether the distributions are made from the deemed IRA or the qualified employer plan. For example, the reporting rules for required minimum distributions apply separately for the two portions of the plan. For a total distribution, two Form 1099-Rs are used – one for the deemed IRA portion (with voluntary 10% withholding) and one for the plan portion (with mandatory 20% withholding), with the 10% early withdrawal penalty applying separately (with somewhat different exceptions) to each portion.

Funding and Deduction Limits – The regulations (and the preamble) confirm that, consistent with the "separateness" concept, deemed IRA assets are not taken into account when determining a plan's assets or liabilities for purposes of the employer's deduction limit (Code § 404) or the minimum funding rules (Code § 412).

Plan Benefits – The regulations (and the preamble) clarify that plan sponsors should be careful not to treat the deemed IRA assets as part of the participant's benefit under the plan. Communications to participants should make this distinction clear.

3. DOL and PBGC Comments

DOL Comments – The preamble to the final regulations offers limited guidance from the Department of Labor ("DOL"). Footnote 1 states that, except for purposes of the exclusive benefit rule, fiduciary and co-fiduciary responsibilities (including 404(c) protection), and administration and enforcement (e.g., claim procedures), the deemed IRA is not treated as part of the pension plan (or as a separate pension plan) for purposes of Title I of ERISA. Therefore, an employer who is subject to ERISA should not report the deemed IRA assets on the plan's (or a separate) Form 5500.

Regarding fiduciary responsibilities, the footnote states:

[F]iduciaries need to take appropriate steps to ensure that they satisfy any fiduciary duties associated with implementation and operation of the deemed IRA feature that is related to a plan covered under title I of ERISA. These duties may include, but not limited to, a duty to monitor the activities of holders of deemed IRAs in order to prevent disqualification of the deemed IRA feature and/or the qualified employer plan where the plan is intended to be maintained as a tax-qualified plan.

It is unclear to what extent fiduciary duties apply to deemed IRAs, especially since it is unclear what activities result in disqualification of a deemed IRA. But what is clear is that the DOL (or a court) may hold the plan fiduciaries liable in the event that the deemed IRA or the plan is disqualified, which will strongly discourage ERISA-covered plans from adding the deemed IRA feature.

PBGC Comments – The preamble to the final regulations reflects the Pension Benefit Guaranty Corporation's (PBGC) treatment of deemed IRAs. The deemed IRA (1) is not covered by Title IV of ERISA, (2) is a separate entity from the plan for Title IV purposes, (3) its benefits/assets are not taken into account in determining PBGC variable-rate premiums, (4) its participants are not taken into account in determining the PBGC's flat-rate participant count, and (5) will be treated as separate from the plan in the event of termination of the plan (so allocation of assets of the plan would ignore the deemed IRA assets/benefits). Also, in the event of plan termination, the fiduciary of the deemed IRA would continue to be responsible for the continued operation, transfer, or termination of the deemed IRA (which would not be subject to Title IV).

Model Amendments for Governmental 457(b) Plans Contain New Guidance

The IRS recently issued Revenue Procedure 2004-56 (to appear in the August 30 IRS Bulletin), which provides model amendments that may be adopted by a state or local government employer (but not non-governmental tax-exempt employers) to ensure that its governmental 457(b) eligible deferred compensation plan terms comply with Code section 457, as amended through EGTRRA, and with the final 457 regulations issued in July 2003. Revenue Procedure 2004-56 supercedes Revenue Procedure 98-41 which provided model amendments addressing the Small Business Job Protection Act of 1996 changes to Code section 457.

The IRS has expressed an interest in receiving comments on the model amendments by November 30.

A. New Guidance in the Model Amendments

The model amendments in Revenue Procedure 2004-56 generally follow the requirements described in the 2003 final 457 regulations. However, the model amendments contain the following provisions that provide some gloss on the IRS' interpretation of the governmental 457(b) plan requirements:

- **Loan Defaults** – The final 2003 457 regulations permit plan loans based on the facts and circumstances of each situation and generally incorporate the Code section 72(p) loan rules applicable to qualified plans. However, the model amendments include detailed language about the timing of, process for, and effect of defaulting on a governmental 457(b) plan loan – including limitations that no contributions can be made by a participant prior to the first payroll period that follows by 12 months the date of repayment in full of the loan and that no new loans may be made from a plan to a participant who has previously defaulted.
- **Mistake of Fact** – Governmental 457(b) plan plans are not subject to ERISA. However, presumably because governmental 457(b) plans are subject to the exclusive benefit rule, the IRS has added a provision to the model amendments adopting the qualified plan mistake-of-fact rule, found in Revenue Ruling 91-4, that contributions made because of a mistake of fact may be refunded within one year after the payment of the mistaken contribution.
- **Missing Participants** – ERISA fiduciaries face an obligation to attempt to track down missing participants. The model amendments appear to pick up on this ERISA-based fiduciary obligation and add a provision requiring that the plan administrator of a governmental 457(b) plan take steps to track down missing participants – including use of the SSA and PBGC participant locator programs. Notably, the provision appears to require a trustee to hold accounts of lost participants indefinitely and does not refer to either forfeiture or escheat after a period of time.
- **Information About Other 457(b) Plan Participation** – The 2003 final 457 regulations provide that where a 457(b) plan participant also makes contributions to an unrelated 457(b) plan, and these contributions cause the participant to exceed the 457 plan contribution limits, the plans will not lose their status as tax-favored eligible deferred compensation plans. The model amendments add a new, ongoing requirement that provides that participants are

obligated to provide the plan administrator with information about their participation in other 457(b) plans.

B. Plan Design Assumptions

Governmental 457(b) plans that are amended to adopt some or all of the model amendments in Revenue Procedure 2004-56 – either on a word-for-word basis or in a form that is substantially similar in all material respects – will be treated as meeting the applicable 457(b) requirements described in the adopted model amendment language. However, the model amendments in Revenue Procedure 2004-56 contain many plan design assumptions that plan sponsors should review before adopting the model amendments. These assumptions include the following:

- **Plan Year** – The model amendments are designed for use with calendar year plans. The model amendments may need to be modified for governmental 457(b) plans based on non-calendar year plan years.
- **Trust Funding Mechanism** – The model amendments are designed for plans that use a trust instead of custodial accounts or annuity contracts to comply with the governmental 457(b) plan trust requirements. Sponsors of plans that use such accounts or contracts should carefully review the model amendments and may have to make changes before adopting them.
- **Definition of Compensation for Contribution Purposes** – The model amendments use the basic definition of compensation under Code section 415(c)(3) in determining "compensation" eligible for contribution to a governmental 457(b) plan. This definition is probably acceptable in most cases, particularly since the model plan assumes that only salary reduction contributions will be allowed. If a plan sponsor wishes to use one of the alternate definitions under the Code section 415 regulations (e.g., the exclusion of certain benefits from plan "compensation") or another non-Code section 415 definition of compensation, it should consider adjusting the model language accordingly. The model language does not address contributions based on termination pay, a controversial piece of the 2003 final 457 regulations.
- **Definition of Includible Compensation for Contribution Limit Purposes** – The model amendments define "includible compensation," which is used for purposes of applying the 100% of includible compensation contribution limit, as W-2 compensation adjusted for elective deferrals. A plan sponsor that wishes to use an alternative definition of Code section 415 compensation (e.g., Code section 3401(a) wages for withholding purposes or standard Code section 415(c)(3) compensation) will need to modify the model amendment language.
- **Definition of Employee** – The model amendments provide that only common law employees are eligible to participate in the plan. The model amendments exclude only collectively bargained employees, unless the agreement provides for participation, but the notes to the model amendments provide that the employee definition may be modified to exclude specific groups of employees. Plan sponsors may also wish to modify the model amendments to cover other individuals such as independent contractors who are not common law employees.
- **Salary Reduction Contributions Only** – The model amendments assume that there will only be salary reduction contributions to a governmental 457(b) plan. If a plan sponsor

wishes to provide for matching or nonelective contributions, additional plan provisions will need to be added.

- **Definition of Employer** – The model amendments do not address the application of the controlled group rules to governmental employers. However, in the section of the model amendments dealing with plan-to-plan transfers, the notes to the model amendments reiterate the position in the 2003 final 457 regulations that an employer is not treated as the same employer if the participant's compensation is paid by a different entity.
- **Timing of Contributions** – The model amendments provide that contributions must be transferred to a governmental 457(b) plan's trust within a reasonable period of time, but no later than the 15th day of the month following the month in which the deferred amount would otherwise have been paid to a participant. This 15th day of the month requirement follows the example of what would be considered a reasonable period of time that is contained in the 2003 final 457 regulations (which, in turn, is generally derived from DOL guidance under ERISA).
- **Contributions While Disabled** – The model amendments permit contributions from compensation (but not disability benefits) paid during a period of disability so long as the participant has not had a severance from employment.
- **Loans of \$10,000 or Less** – The model amendments do not provide for the optional rule that loans of \$10,000 or less can exceed one-half of a participant's account.
- **Loan Interest Rate** – The model loan provisions specify an interest rate 1% above the prime rate as published in a plan-specified nationally recognized newspaper as of the first business day of the month in which the loan is approved.
- **Loan Repayments by Payroll Deduction** – The model amendments state that loan repayments must be by payroll deduction, except during leaves of absence when a participant's paycheck is insufficient. However, a note to the model amendments provides that payroll withholding is not required.
- **Mandatory In-Service Cashouts** – The model amendments provide that small accounts of \$5,000 or less will be cashed out if there has been no prior distribution and no deferrals have been made in the prior two years. The notes to the model amendments state that a governmental 457(b) plan may allow such distributions to be at the election of the participant.
- **Unforeseeable Emergency Distributions** – The model amendments provide that unforeseeable emergency distributions are available to participants only. The 2003 final 457 regulations permit unforeseeable emergency distributions to participants or beneficiaries.
- **Forms of Distribution** – The model amendments provide for distributions to be made in lump sums and installments, but do not refer to annuities. However, the notes to the model amendments state that other forms of benefit may be included.
- **Separate Accounts for Multiple Beneficiaries**- The model amendment provides that separate accounts will be established when a deceased participant has multiple beneficiaries. Plan sponsors should consider whether their governmental 457(b) plan will be able to track these separate accounts.

- **After-Tax Rollovers to a Governmental 457(b) Plan** – The model amendment provisions addressing rollovers contributions into a governmental 457(b) plan do not expressly bar after-tax contributions. However, presumably, such after-tax rollovers to a governmental 457(b) plan would not be permissible. Furthermore, the model amendment provisions state that all rollovers – even from governmental 457(b) plans – will be separately accounted for. Presumably, this separate accounting is designed to allow a governmental 457(b) plan to make in-service distributions of rolled-in amounts (as permitted by Rev. Rul. 2004-12).
- **Domestic Relations Orders** – The domestic relations order provisions of the model amendments allow a governmental 457(b) plan to generally follow domestic relations orders, even if the participant is not eligible for a distribution. Plans that wish to be more restrictive by not permitting early distributions or following all of the qualified domestic relations order rules would have to modify this provision.
- **Local Law Provisions** – Some governmental 457(b) plans may be subject to state or local-level requirements beyond or different than those set forth in Code section 457 and the 2003 final 457 regulations. Plan sponsors should review the language in the model amendments as to whether it complies with local law requirements.

C. Adopting the Model Amendments/Effect on Letter Rulings

In addition to the many plan design issues discussed above, governmental 457(b) plan sponsors should be aware that the model amendments are not a "one-stop" solution to legal compliance. Other legal considerations include the following:

- **Effect of Model Amendments** – Although the model amendments will be treated as bringing a plan document in compliance with the Code section 457(b) requirements, an adopting governmental 457(b) plan's operation must also comply with the written plan terms.
- **Timing of Adoption of Model Amendments** – The 2003 final 457 regulations were generally effective for plan years beginning after 2001. Revenue Procedure 2004-56 provides that the model amendments (or substantially similar amendments) will be treated as timely adopted if they (1) are adopted no later than December 31, 2005, (2) are made effective as of a date consistent with the Code section 457(b) requirements, and (3) plan operations after the effective date are consistent with the plan amendment. As such, governmental 457(b) plans should focus on bringing their plans into compliance with EGTRRA and the 2003 final 457 regulations no later than December 31, 2005. Revenue Procedure 2004-56 does not indicate what effect the so-called statutory "flush language" permitting special governmental plan corrections may have on any failure to meet the December 31, 2005, deadline.
- **Effect on Private Letter Ruling Requests** – The model amendments appear to be designed to allow governmental 457(b) plan sponsors to obtain a level of comfort that their plan documents comply with the Code section 457(b) requirements without requesting a private letter ruling from IRS. Should an employer wish to obtain a private letter ruling on its governmental 457(b) plan, Revenue Procedure 2004-56 provides that the ruling request must clearly highlight and describe in the written request how the submitted plan's provisions differ from the model amendments.

Proposed DOL Regulations on USERRA

Ten years in the making, the Veterans and Employment Training Service of DOL has now released proposed regulations under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), which protects employees while absent from work due to military service. 69 Fed. Reg. 52625, Sept. 20, 2004. The proposed regulations (along with the preamble) are comprehensive and clarify a number of open issues for employers in a helpful question-and-answer format. The proposed regulations deal with a broad array of USERRA questions regarding reemployment rights and employment discrimination. For plan sponsors, they are particularly helpful in sorting out several employee benefit plan issues. The key clarifications affecting retirement plans are highlighted below and primarily affect the rights and duties of employees and employers upon return to service. Although not discussed here, the proposed regulations also provide guidance on the special health care continuation coverage rules of USERRA (including under multiemployer plans), but do not address how USERRA continuation coverage relates to COBRA continuation coverage.

Timing of Employer Contributions for Reemployed Service Members – In general, employer contributions to a retirement plan that are not contingent on employee contributions or elective deferrals (e.g., profit-sharing contributions, money-purchase plan contributions, discretionary employer contributions) for a reemployed service member must be made within 30 days following reemployment. However, if it is impossible or unreasonable for the employer to make the contributions, they must be made as "soon as practicable." Some employers may find the 30-day rule to be too short to determine deemed compensation and calculate and contribute funds.

Partial Employee Contributions – Employees are permitted to make-up missed employee contributions or elective deferrals (e.g., after-tax amounts, pre-tax deferrals, mandatory employee contributions, and, although the regulations are silent, apparently so-called governmental plan "pick-up" contributions under Code section 414(h)) in whole or in part, in accordance with plan terms or consistent administrative practices. To the extent such employee contributions or elective deferrals are made, employers must make any related contributions contingent on such contributions, such as matching contributions, in accordance with the plan's requirements for the time for making matching contributions. For employees no longer employed, employers must permit after-tax contributions instead of pre-tax deferrals, which must be treated the same as pre-tax deferrals for employer matching contribution purposes. (Notably, the proposed regulations offset any right to make contributions by any deferrals made during the military service, which implies that deferrals can be made from "differential pay.")

Repayment Option – Employees who withdrew all or any part of their qualified plan benefit (either defined benefit ("DB") or defined contribution ("DC") prior to entering military service have the option to repay that amount (with interest that would have accrued but for the withdrawal, in the case of a DB plan), resulting in appropriate credit under a DB plan or a reinstated account balance under a DC plan, presumably including amounts forfeited in connection with the distribution. This option, which is broader than the Code's general repayment option for rehires, is generally available for a period extending from the time of reemployment until three times the length of military service, but not to exceed 5 years.

Multiemployer Plans – The proposed regulations provide rules for applying USERRA to multiemployer pension plans. (Multiple employer plans appear to be subject to the rules for single employer plans.) Generally, unless the plan provides otherwise, the last employer that employed the service member before leave commenced is responsible for the employer contribution. The reemploying

employer must provide notice of reemployment to the plan administrator within 30 days. The returning service member is entitled to the same employer contribution (or benefit accrued), whether reemployed by the pre-service employer or a different participating employer. In any case, the plan will have liability for the associated benefit.

Leave of Absence and Effect on Benefits – The proposed regulations state that, during a period of service in the uniformed services, the service member is deemed to be on leave of absence, and entitled to non-seniority based "rights and benefits generally provided to other employees with similar seniority, status and pay that are on furlough or leave of absence." For this purpose, where those rights or benefits vary depending upon the type of leave, the service member must be given "the most favorable treatment afforded to any comparable form of leave...." Employers that offer special pay or continued benefits, such as paid health coverage, life insurance, or profit-sharing, to employees on leave, should carefully evaluate their obligations under this standard.

The DOL is seeking public comments by November 19, including on whether the 30-day period is too long or too short, and whether the repayment option should apply to DC plans. The final regulations may be effective as soon as 30 days after publication.

DOL Adopts Safe Harbor Default IRA Rule and In-House Class Exemption

In March, the Department of Labor ("DOL") proposed a safe harbor rule that would protect fiduciaries of the plans with mandatory cashout requirements from fiduciary liability under the Employee Retirement Income Security Act of 1974 ("ERISA") that may result from complying with the Code's mandatory default IRA provision. 69 Fed. Reg. 9900 (March 2, 2004) ("default IRA rule"). As a companion to the proposed rule, DOL issued a proposed class exemption for financial institutions that sponsor their own plans to allow them (or their affiliates) (i) to be IRA providers for mandatory distributions from their in-house plans, (ii) to select an investment product in which they (or their affiliates) have an interest, and (iii) to receive fees in connection with these services. 69 Fed. Reg. 9846 (March 2, 2004).

On September 28, DOL issued the much anticipated final regulation and adopted the class exemption, with some key modifications. 69 Fed. Reg. 58018, 69 Fed. Reg. 57964. The default IRA rule will apply to any rollover of a mandatory distribution made on or after March 28, 2005. DOL indicated that fiduciaries may rely in good faith on the regulation even prior to the effective date. The class exemption, however, cannot be relied upon prior to the effective date of March 28, 2005.

The IRS is currently working on guidance, which we anticipate will include (1) a sample IRS plan amendment, (2) revised rollover notice that explains these new rules, (3) applicability of these rules on governmental, church and other non-ERISA plans, and (4) other miscellaneous guidance on the scope of these rules.

We discuss the differences between the final versions and the proposals below.

A. The Default IRA Rule

1. Proposed Rule

Under DOL's proposed regulation, a fiduciary is deemed to have satisfied his or her fiduciary duties under section 404(a) of ERISA – with respect to both the designation of an IRA provider and the initial investment choice for the IRA – if the arrangement meets the following requirements:

Amount. The cash-out amount (excluding prior rollover contributions) is more than \$1,000 but less than \$5,000.

Type of Account. The mandatory cash-out must be directed to an Internal Revenue Code ("IRC") § 408(a) individual retirement account or an IRC § 408(b) individual retirement annuity.

Type of Investment. The proposed regulation limited investments to investment products designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity and taking into account the extent to which charges can be assessed against the account (e.g., money market funds, interest-bearing savings accounts, certificates of deposits, and "stable value products."). The investment products must be offered by a regulated financial institution, such as a bank the deposits of which are insured by the Federal Deposit Insurance Corporation.

Permissible Fees and Expenses. The fees and expenses relating to the IRA may include set-up charges, maintenance fees, investment expenses, terminations costs and surrender charges – subject

to two limitations. First, the fees and expenses relating to the "cash-out" IRA may not exceed the fees and expenses charged by the provider for comparable IRAs established for voluntary rollover distributions. Second, the fees and expenses (except for the set-up charges) may be charged to the IRA only to the extent of the income earned by the IRA. In other words, fees may not be charged against the IRA's principal.

Disclosure. Before the mandatory cash-out, participants must be furnished with a summary plan description ("SPD") or a summary of material modifications ("SMM") that includes an explanation of the mandatory cash-out process, including an explanation that the mandatory cash-out will be invested in an investment product designed to preserve principal and provide a reasonable rate of return and liquidity, a statement explaining the allocation of fees and expenses, and the name, address and phone number of a plan contact who may provide further information on the cash-out.

No Prohibited Transaction. The fiduciary's selection of an IRA and of an investment product must not result in a non-exempt prohibited transaction.

2. Final Rule

The most significant revisions to the final rule include:

modifying the permissible rollover amount to allow its use for mandatory cashouts under \$1,000, adding a requirement for an express written agreement with IRA providers, and the elimination of the "income" cap on fees.

DOL adopted, as proposed, requirements regarding the type of investment products, notice to participants, and the "no prohibited transaction" requirement.

Rollover Amounts Under \$1,000. DOL extended the applicability of the safe harbor rule to mandatory distributions of \$1,000 or less. 29 C.F.R. § 404a-2(d). Presumably, the IRS would agree but the Code's provisions technically do not apply to such distributions. See Rev. Rul. 2000-36, 2000-2 C.B. 140. The question whether an outstanding participant loan should be counted in determining the \$5,000 threshold was referred to the Department of Treasury and the IRS for consideration. We anticipate that the answer should be yes.

New Requirement for Written Agreement with IRA Provider. The final rule adds an explicit requirement for a written agreement between the plan and the IRA provider on which the plan fiduciary may rely under the safe harbor regulation. The agreement must contain representations with respect to specific requirements of the safe harbor rule, including the type of investments for rolled-over funds and the attendant fees and expenses. DOL believes that such information is already being included in the documents currently utilized by the IRA providers, and that no special documents would have to be prepared for purposes of safe harbor. (Nevertheless, prototype IRA documents will likely need to be revised to reflect the safe harbor limitations.) Notably, the plan fiduciary is not required to monitor the provider's compliance with the agreement's representations beyond the point in time when the funds are rolled over into the account in accordance with the agreement. DOL confirmed that following the rollover, the participant will be treated as exercising control over the assets in the IRA account for purposes of ERISA section 404(c).

Elimination of the "Income" Fee Cap. In response to a significant number of negative comments, DOL dropped the proposed limitation that the fees and expenses charged to the IRA (other than set-up costs) could not exceed the income earned by that account. The only fee and expense limitation retained by the final rule is that fees and expenses must be comparable to the fees and

expenses charged for comparable IRAs established for rollover distributions other than these mandatory cashouts.

B. Applicability of the Default IRA Rule to Distributions of Missing Participants in Terminated Plans

In guidance issued by DOL two days after publishing the default IRA regulation, DOL stated that fiduciaries of terminated defined contribution plans could rely on the default IRA regulation in rolling over accounts of participants who are determined to be missing or otherwise fail to elect a method of distribution in connection with the plan termination. Field Assistance Bulletin No. 2004-02 (Sept. 30, 2004). Significantly, the safe harbor rule would protect such fiduciaries regardless of the amount involved in the mandatory rollover distribution for missing participants.

C. In-House Class Exemption

With one exception, DOL adopted the proposed class exemption without substantial modification. As with the default IRA rule, DOL extended the applicability of the exemption to the mandatory cashouts of \$1,000 or less.

Unlike with the final default IRA rule, the final class exemption does *not* eliminate the cap on the permissible amount of fees (other than set-up charges) to the income earned by the account. Accordingly, financial institutions that intend to rely on this exemption for cashing out participants from their in-house plans and placing them in the proprietary IRAs would need to ensure they comply with the income fee cap.

Finally, according to DOL, the class exemption would not be available to financial institutions that have not previously provided comparable IRA accounts because they would not meet the condition that the fees and expenses charged for the mandatory rollover accounts must be comparable to the fees and expenses charged for comparable IRAs established for reasons other than the receipt of mandatory cashouts.

With respect to missing participants in in-house plans, unlike the default IRA rule, the class exemption's protection would be limited to distributions of up to \$5,000 (plus the rollovers if the plan so provides).

Summary of Deferred Compensation Legislation

On Thursday, the House approved far-reaching changes in the federal tax laws that apply to nonqualified deferred compensation plans. These changes are included in the American Jobs Creation Act of 2004 (the "Act"). The Senate is expected to pass the Act, and the President is expected to sign it into law, shortly.

The Act adds a new section 409A to the Internal Revenue Code ("Code") that applies to amounts "deferred" (generally, earned and vested) after 2004. For the first time, the Code would provide specific rules for deferral elections, distributions, and funding mechanisms under nonqualified deferred compensation plans. We outline below the key portions of the Act and the accompanying conference report.

Definition of Nonqualified Deferred Compensation Plan

A "nonqualified deferred compensation plan" is defined in section 409A as any plan that provides for the deferral of compensation. In addition to plans that permit participants to elect to defer compensation, nonqualified defined benefit plans (*i.e.*, "SERPs") are covered by the definition. Further, any plan, arrangement, or agreement, including those covering only one person, is covered. The conference report also makes clear that plans covering non-employees are covered by the new rules. Plans that are specifically excepted from the definition are limited to:

- tax-qualified plans, tax-deferred annuities, 457(b) plans, SEPs, SIMPLEs, and qualified governmental excess benefit arrangements under section 415(m),
- plans that are exempt from section 457 under section 457(e)(12) and meet certain other requirements, and
- any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

According to the conference report, the new rules will not apply to annual bonuses or other annual compensation amounts paid within 2 ½ months after the close of the year in which the relevant services required for payment have been performed. Absent favorable IRS guidance, severance plans would appear to be subject to the new rules.

Equity Compensation Plans

Many common equity compensation arrangements could be said to involve a deferral of compensation and thus be subject to the new rules. Fortunately, the conference report provides that fair market value nonqualified stock options, incentive stock options, and employee stock purchase plans are not subject to the new legislation. The conference report makes clear that stock appreciation rights ("SARs") are covered by the legislation, but states that the IRS may address issues related to SARs in regulations. Restricted stock and restricted stock units are not addressed in the Act or the report, so their status may be determined by IRS regulations.

Initial Deferral Elections

Section 409A requires initial participant elections to defer compensation to be made before the beginning of the taxable year in which the services are performed giving rise to the compensation, or at such other time as provided in regulations. An exception to this general rule provides a 30-day election period for newly eligible participants. Another important exception is for "performance-based compensation" earned over a period of at least twelve months. Under section 409A, an initial election to defer such compensation may be made as late as six months prior to the end of such period. As noted below, constructive receipt rules under Code section 451 would still apply to such an election, and could impose additional limitations.

The conference report states that it is intended that the IRS will define "performance-based compensation" to include an amount to the extent it is: (1) variable and contingent on the satisfaction of pre-established organizational or individual performance criteria, and (2) not readily ascertainable at the time of the election. Further, the report provides that performance-based compensation may need to meet certain requirements similar to those under Code section 162(m), but would not be required to meet all requirements under that section. For example, the report states that it is expected that the IRS will provide that performance criteria would be considered pre-established if established in writing no later than 90 days after the commencement of the service period, but the section 162(m) requirement that the company's compensation committee determine the criteria would not be required.

A bonus based on objective criteria established in writing on a timely basis will likely be considered "performance-based compensation." Thus, if a participant is entitled to a bonus payable in 2007 based on the employer achieving a certain level of earnings per share for 2006, the participant may be able to make an election as late as June 30, 2006 to defer payment of the bonus.

Distributions

The time and form of distribution for a deferred amount must be specified either in the plan or by the participant at the time of deferral. Deferred amounts may be distributed only upon:

- separation from service (as determined by IRS),
- death,
- disability,
- a specified time or pursuant to a fixed schedule (which may be elected by the participant at the time of deferral),
- a change in ownership or effective control of the employer, or in the ownership of a substantial portion of the assets of the employer, to the extent provided in IRS regulations (under similar, but more restrictive, standards to the golden parachute rules in Code section 280G), and
- an unforeseeable emergency (under standards similar to the unforeseeable emergency requirements in the final Code section 457 regulations).

A participant will be considered disabled for this purpose if either (1) the participant is disabled within the meaning of the Social Security Act, or (2) the participant is receiving income replacement benefits for a period of at least three months under an accident and health plan of the employer, by reason of a medically determinable physical or mental impairment which can be expected to result in death or last for a continuous period of at least 12 months. Payments to "key employees" (as defined under the Code section 416(i) top heavy rules, which would include up to 50 officers) of a publicly traded corporation may not be made in the first six months following the individual's separation from service.

Acceleration Generally Prohibited

The acceleration of payments before the time or schedule specified at the time of deferral is prohibited, except as provided by IRS regulations. This rule would eliminate the use of so-called "haircut" provisions. Also, changes in the form of payment that would result in an acceleration of payments (e.g., from an annuity to a lump sum) would not be permitted.

The conference report indicates that a choice between cash and taxable property will not violate the prohibition if the timing and amount of income inclusion is the same regardless of the medium of distribution. For example, the choice between a fully taxable annuity contract and a lump sum payment may be permitted. The conference report also states that it is intended the IRS will provide:

- rules under which the choice between different forms of actuarially equivalent life annuity payments is permitted,
- other limited exceptions, such as when an accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective, e.g., to comply with a court-approved divorce settlement,
- that a plan would not violate the prohibition by providing that withholding of an employee's share of employment taxes will be made from the employee's interest in the plan,
- that a plan would not violate the prohibition by making a distribution to a participant to pay income taxes upon a section 457(f) vesting event, and
- that a plan would not violate the prohibition by providing for automatic distributions of minimal account balances upon permissible distribution events for purposes of administrative convenience, e.g., automatic cashout of account balances less than \$10,000.

Subsequent Deferral Elections

Any subsequent election to delay the timing or change the form of payment generally must (1) not take effect until at least 12 months after the date of the election, (2) provide an additional deferral for a period of at least five years from the date such payment would otherwise have been made, except in the case of elections relating to distributions on death, disability, or unforeseeable emergency, and (3) if related to a payment at a specified time or pursuant to a fixed schedule, be made at least 12 months prior to the date of the first scheduled payment. The conference report states that the IRS may also issue regulations in this area regarding elections with respect to payments under nonelective plans, e.g., SERPs.

Senate Proposals Not Included in Act

The Act does not include provisions relating to restrictions on investment control and the prohibition on deferrals of stock option gains and other equity compensation, which were included in the Senate's version of the legislation (S. 1637, the "Jumpstart Our Business Strength (JOBS) Act of 2004).

Effect of Violations

If the deferral election or distribution requirements of section 409A are violated as to a participant, all amounts deferred for the participant under a plan (including earnings) for all taxable years are taxed immediately, except to the extent the amounts are subject to a substantial risk of forfeiture. Interest at the underpayment rate plus one percent is imposed on the underpayments that would have occurred had the

compensation been taxable when first deferred or, if later, when not subject to a substantial risk of forfeiture. A twenty-percent additional tax is also imposed upon the amount of compensation which is required to be included in a participant's gross income.

Unlike provisions in earlier versions of the legislation, a violation will only result in taxation for the participants with respect to whom the violation relates. For example, if two plan participants improperly receive distributions before one of the specified events listed above, no other participants will be affected by the violation. However, if a plan document contains a provision that violates the requirements, all plan participants could be subject to immediate taxation. The conference report does make clear that a violation of the new rules will only cause adverse tax results for the portion of a plan subject to the new rules (generally the post-2004 deferrals).

Offshore Rabbi Trusts

Assets set aside (directly or indirectly) in an offshore trust for the purposes of paying nonqualified deferred compensation are treated as property transferred under Code section 83 at the time set aside or transferred outside the U.S., whether or not the assets are available to satisfy claims of general creditors. Earnings on such assets are treated as additional transfers of property. Thus, participants would be immediately taxed on deferred amounts when they are no longer subject to a substantial risk of forfeiture. Interest and the twenty-percent additional tax as described above would also apply.

This rule does not apply to assets located in a foreign jurisdiction if the deferred compensation relates to services performed in such offshore jurisdiction, and the IRS is granted regulatory authority to provide exceptions for arrangements that will not result in the improper deferral of U.S. tax and where assets will not be effectively beyond the reach of creditors.

Financial Distress Triggers

A transfer of property occurs under Code section 83 with respect to deferred compensation if a plan provides that, upon a change in the employer's financial health, assets will be restricted to the provision of plan benefits. Surprisingly, section 409A provides that such a transfer occurs even if the "restricted" assets are subject to the claims of creditors. Thus, the conference report states that a transfer to a rabbi trust (where amounts remain subject to the claims of creditors) upon a change in the employer's financial health will implicate this provision. Fortunately, the report goes on to state that the provision is not intended to apply when assets are restricted for a reason other than a change in financial health (e.g., upon a change in control) or if assets are periodically restricted under a structured schedule and scheduled restrictions happen to coincide with a change in financial status.

Earnings on restricted assets are treated as additional transfers of property. Thus, participants would be immediately taxed on deferred amounts when they are no longer subject to a substantial risk of forfeiture. Interest and the additional twenty-percent tax as described above would also apply. The IRS is granted regulatory authority to provide exceptions for arrangements that will not result in the improper deferral of U.S. tax and where assets will not be effectively beyond the reach of creditors.

Effect of Other Code Sections

Section 409A makes clear that another section of the Code may require a deferred amount to be includible in income earlier than required under section 409A. For example, section 451 (constructive receipt rules) or section 83 (compensatory transfers of property) may require inclusion before section 409A. However, once an amount is included under section 409A, it will not be includible under any such other section.

Effective Date

Section 409A applies to "amounts deferred" after 2004. The Section applies to earnings on deferred amounts only to the extent that such deferred amounts are subject to the Section.

The conference report states that for purposes of the effective date, an amount is considered deferred before 2005, if the amount is earned and vested before such date. Using stock appreciation rights ("SARs") as an example, the report provides that SARs that are vested before 2005 are not subject to the new rules (subject to the material modification rule discussed below). SARs that are not vested before 2005 are subject to the new rules.

Amounts deferred under a plan before 2005, are subject to the new rules only if the plan is "materially modified" after October 3, 2004. The statute provides that a plan may be amended in accordance with IRS guidance to add the new rules for post-2004 deferrals without jeopardizing the grandfathered status of pre-2005 deferrals under the plan. The conference report provides guidance on whether other modifications may subject pre-2005 deferrals to the new rules. Specifically, the report states that the addition of any benefit, right, or feature is a material modification, while the exercise or reduction of an existing benefit, right, or feature is not. The report analyzes several examples of modifications as follows:

- an amendment to add a provision that distributions may be allowed upon request if participants are required to forfeit 10 percent of the amount of the distribution (i.e., a "haircut") is a material modification,
- accelerating vesting under a plan is a material modification,
- a change in the plan administrator is not a material modification,
- amending a plan to remove a distribution provision (e.g., to remove a "haircut") is not a material modification.

The report also makes clear that a subsequent deferral election may be made with respect to an amount originally deferred prior to 2005 without subjecting the amount to the new rules.

Transition Relief

The IRS is directed to issue guidance within 60 days of enactment permitting a limited period of time during which deferred compensation plans adopted before December 31, 2004, may be amended to (1) permit participants to terminate participation or cancel an outstanding deferral election with regard to amounts deferred after December 31, 2004, provided that those amounts are includible in income as earned (or if later, when no longer subject to a substantial risk of forfeiture), and (2) conform with the requirements of section 409A for amounts deferred after December 31, 2004.

The conference report provides that it is expected the IRS may provide exceptions to certain requirements during the transition period (e.g., the rules regarding timing of elections) for plans coming into compliance with the new rules. Further, the report states that it is expected that the IRS will provide a reasonable time, during the transition period but after the issuance of guidance, for plans to be amended and approved by the appropriate parties.

Reporting and Withholding

Amounts deferred under a nonqualified deferred compensation plan would be required to be reported to the IRS on an individual's Form W-2 (or Form 1099-MISC for non-employees) for the year deferred. IRS is granted regulatory authority to establish a minimum amount of deferrals under which the Form W-2 reporting would not be required. The conference report also states that the IRS may provide

for later reporting of amounts deferred under a nonaccount balance plan (e.g., a SERP) which are not "reasonably ascertainable."

Amounts required to be included in income under section 409A will need to be reported on a Form W-2 (or Form 1099-MISC for non-employees) for the year included, and includible amounts for employees will be subject to Federal income tax withholding.

Direction to IRS

The IRS is directed to issue regulations to carry out the purposes of these new rules, including regulations relating to the treatment of nonqualified defined benefit plans, changes in control of a corporation, the standard for determining a change in an employer's "financial health," and disregarding a substantial risk of forfeiture where necessary to carry out the purposes of the legislation.