

QUALIFIED PLANS 2004-8

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1. **IRS Guidance Priorities for 2004-05**

For a number of years now, IRS and Treasury have jointly developed a list of areas in which they intend to release guidance – such as regulations, revenue rulings and other published official authority – during the year. For the most part, IRS and Treasury have succeeded in issuing guidance on substantially all of the items on these "business plan" or "guidance priority" lists. Experience has shown that few things that are not on the list get done – although the list does not cover exam guidelines, field directives, and other documents directed primarily at IRS agents.

The 2004-05 "guidance priorities" were announced on July 26. We have attached the list of expected items in the employee benefits area for the period July 2004 through June 2005. Most of the descriptions are quite general so it is hard to tell what will be forthcoming. Many reflect further action on proposed or temporary rule projects that were previously published. As always, employee benefits is one of the longer lists – 47 out of 276 listed

projects. We expect quarterly updates to this list adding new projects – primarily in response to legislative or other external developments.

Some significant items on the new list include

- guidance on Roth 401(k) arrangements, which first become available as a plan design option for 2006,
- guidance on default rollovers of involuntary cashouts between \$1,000 and \$5,000,
- comprehensive final regulations for 401(k)/(m) plans,
- a long-overdue update of the section 415 regulations (carried over from last year's plan),
- guidance on the use of electronic technologies for various retirement plan transactions, which we think is primarily

intended to update the existing rules in this area to reflect the federal E-sign legislation, but also might include spousal consent and other areas where guidance has been lacking,

- guidance on when or under what circumstances 401(k) and other elective deferrals may be made from severance pay, and
- guidance on a variety of executive compensation issues including section 83 and secular trusts.

We note that a number of items from the 2003-04 lists have not been issued, but are still expected – including comprehensive proposed rules for 403(b) plans and guidance on "phased retirement" issues.

2. SEC Amends 12b-1 Rule to Prohibit Directed Brokerage Arrangements

The Securities and Exchange Commission ("SEC") continues to act on its rulemaking initiatives proposed as a result of scandals in the mutual fund industry. At an open meeting on August 18, the SEC voted unanimously to amend Investment Company Act rule 12b-1 to prohibit mutual fund brokerage from being used to compensate broker-dealers for promoting and selling mutual fund shares.

Generally, rule 12b-1 allows mutual funds to pay certain "distribution" expenses, including sales commissions, if the fund adopts a so-called "12b-1 plan" and meets certain other conditions. The amendment to rule 12b-1 approved by the SEC on August 18 would –

- prohibit mutual funds from compensating broker-dealers for promoting or selling their fund shares by directing brokerage transactions to that broker-dealer;
- prohibit "step-out" and similar arrangements under which a fund directs brokerage commissions to selling brokers that do not execute fund portfolio securities transactions as compensation for selling mutual fund shares; and

- require mutual funds to adopt policies and procedures to preclude "quid pro quo" arrangements with respect to the sale of their shares.

The amendment to rule 12b-1 should not affect how 12b-1 fees and other compensation paid by mutual fund complexes is used by recordkeepers and other benefit plan service providers to reduce or offset their costs in providing plan services. However, the SEC is still considering the future of rule 12b-1 itself. In this regard, the SEC's February proposal to amend rule 12b-1 to prohibit directed brokerage arrangements included a request for comments on whether the rule should be amended in a more comprehensive way or possibly even repealed. So far, the SEC has received more than 1,600 comment letters, and is now in the process of reviewing them.

According to SEC Chairman Donaldson, the following three mutual fund-related rule proposals remain outstanding –

- the proposed hard 4 p.m. deadline for mutual fund trades (Qualified Plans 2003-12),
- proposed mandatory redemption fees (Qualified Plans 2004-3), and
- new disclosure requirements on point-of-sale and confirmation statements (Qualified Plans 2004-2).

The SEC expects to act on all of these by the end of the year.

3. IRS Issues Final ISO Rules and Requests Comments on ESPP Rules

The IRS issued a complete set of final regulations on incentive stock options ("ISOs") on August 3. 69 Fed. Reg. 46401. The regulations provide guidance under the following Code sections:

- section 422, which authorizes ISOs and spells out the requirements;
- section 421, which governs the income tax treatment of ISOs as well as transactions under employee stock purchase plans governed by Code section 423 ("ESPPs"); and

- section 424, which provides special rules for ISOs and ESPP options.

The final regulations essentially adopt the proposed regulations issued in June 2003 (Qualified Plans 2003-6) with limited revisions. On the same date the final ISO regulations were issued, the IRS issued a Notice requesting comments on possible revisions to the ESPP regulations under Code section 423. Notice 2004-55 (August 9 IRS Bulletin).

We describe below some of the more significant changes the final ISO regulations made to the proposed regulations, and summarize the IRS request for comments on the ESPP regulations.

A. Final ISO Regulations

Maximum Number of Shares – In order for an option to qualify as an ISO, the plan under which the option is granted must specify the maximum number of shares that may be issued under the plan pursuant to ISOs. This requirement could present a problem for a purported ISO issued under a plan that was previously approved by shareholders and does not contain such a limit. The final regulations eliminated a provision in the proposed regulations that would have required a plan to contain limits on the number of shares that could be issued pursuant to nonqualified options and other stock-based awards.

The preamble to the final regulations indicates that only the net number of shares issued upon exercise of an option counts against the maximum number of shares issuable under ISOs (*i.e.*, shares used to pay the exercise price do not count).

Modifications – A modification of a statutory option results in a new grant that will qualify as a statutory option only if it meets the applicable requirements on the date of grant. The final regulations provide that the following will not result in modifications:

- an offer to change the terms of an option, if the change is not made and the offer remains outstanding for less than 30 days;
- an "inadvertent" change to an option's terms that would otherwise constitute a modification, to the extent the change is reversed by the earlier of the date of exercise or the end of the calendar year in which the change occurred; and

- the exercise by the granting corporation of discretion specifically reserved under the option related to the payment of employment taxes and/or withholding taxes related to the exercise of the option.

Shareholder Approval – In a corporate transaction, statutory options held by employees of a target company are often assumed by the acquiring company or replaced with options on the acquiring company's stock. The final regulations removed a rule in the proposed regulations that could have required shareholders of the acquiring company to approve such assumptions or replacements.

Electronic Statements – Code section 6039 generally requires an employer to provide a statement to an optionee who receives shares pursuant to the exercise of a statutory option during a year by the following January 31. The final regulations provide that such a statement may be furnished electronically with the consent of the optionee.

Section 83(b) Elections – The regulations provide that a Code section 83(b) election made upon the exercise of a statutory option will apply only for purposes of the alternative minimum tax, not for regular federal income tax purposes.

Effective Date - The regulations are effective August 3, 2004, but the following transitional rules apply:

- For statutory options granted on or before June 9, 2003, taxpayers may rely on the 2003 proposed regulations, proposed regulations issued in 1984, or the final regulations until the earlier of January 1, 2006 or the first regularly scheduled stockholders meeting occurring six months after August 3, 2004.
- For statutory options granted after June 9, 2003 but before the earlier of January 1, 2006 or the first regularly scheduled stockholders meeting occurring six months after August 3, 2004, taxpayers may rely on the 2003 proposed regulations or the final regulations.

Taxpayers may not rely on the 1984 or 2003 proposed regulations after December 31, 2005. Reliance on any set of regulations must be in its

entirety and all statutory options granted during the reliance period must be treated consistently.

B. Request for Comments on ESPP Regulations

The IRS announced in Notice 2004-55 that it is considering whether revisions should be made to the longstanding ESPP regulations under Code section 423 to make them consistent with the newly finalized ISO regulations. The Notice also listed eight additional issues that could be addressed in such revisions, including:

- whether any subcategory of employees may be excluded from plan participation and whether the exclusion of foreign employees should be addressed;
- the effect of an inadvertent exclusion of employees;
- the treatment of new employees and new plan participants;
- whether the \$25,000 annual limit on purchases under an ESPP should be determined in a manner consistent with the \$100,000 limit for ISOs;
- limitations on changes to contribution amounts under a plan; and
- whether employees should be able to carry over contributions from an earlier plan or offering period to a new plan or offering period.

Taxpayers are encouraged to comment – by October 1 – on whether these issues and/or others should be addressed in revisions to the ESPP regulations.

4. IRS Reproposes "Source" Rules For Compensation Attributable to US and Foreign Services

In early 2000, the IRS issued a proposed regulation regarding the proper "sourcing" of compensation (including fringe benefits) for U.S. taxpayers and non-resident aliens (Qualified Plans 2002-2). The proposed regulation would replace the "facts and circumstances" test for individuals that work both within and without the United States during the year with a required allocation of the

compensation based on time spent here and abroad. Prop. Treas. Reg. § 1.861-4(b). According to the IRS, it was intended to provide for more consistent tax treatment of fringe benefits, and to prevent the "total avoidance" of taxation on such fringe benefits.

Among other areas, this rule is important for qualified plans, because the allocation is used to determine the source of pension and savings plan contributions for nonresident aliens and Puerto Rican residents, and, therefore, the extent to which U.S. tax and pension rules apply upon later distribution from the plan (or, for US citizens, the extent that a foreign tax credit is available). Although IRS recently announced "safe harbor" guidelines for making allocations under defined benefit plans (Rev. Proc. 2004-37), these proposed rules would apply more generally, including for defined contribution plans as well as most other forms of employment-related benefits.

Based on comments criticizing the 2000 proposal, the IRS just released new proposed regulations that replace the prior proposed regulations. 69 Fed. Reg. 47816 (Aug. 6, 2004). The new proposed rules are summarized below, and vary based on who received the compensation and the type of compensation.

Non-Employee Individuals (i.e., Entity or Independent Contractor) – As under current rules, a facts and circumstances test would apply to determine the basis that most correctly reflects the proper source of the compensation paid to a non-employee. The preamble and the proposed regulation explain when the "relative payroll" costs more accurately reflect income for an entity than a pure "time basis" allocation.

Employees – The IRS continues to propose to source employee compensation on a time-basis reflecting days (or more frequent units) in the calendar year (or specific period). The time-based approach also would be used for multi-year compensation, but over the "applicable period" to which the compensation is attributable. The applicable period is determined on a facts and circumstances basis, which may provide some flexibility for deferred compensation arrangements, stock options, etc. Under this approach, a nonqualified stock option that vests after 5 years and has no readily ascertainable fair market value at grant is generally sourced based on where services are performed during the vesting period. However, Treasury and IRS invited further comments on

whether alternate bases for sourcing multi-year compensation are appropriate.

The IRS proposes two exceptions to the time-based allocation rule:

- **Fringe Benefits.** The IRS has designated certain fringe benefits as sourced on a geographical basis – generally, at the employee's principal place of work where the benefit is provided – assuming the fringe benefit is reasonable and substantiated. Key benefits include housing, transportation, moving expenses, and tax equalization.
- **Alternative Basis.** At the election of the employee (or group of employees), the compensation can be sourced under another method that more properly reflects its source, based on a facts and circumstances test. For example, an alternative basis may be used if compensation is tied to the performance of specific actions rather than earned ratably over a specific time period. Information substantiating why the chosen method is more appropriate must be maintained. Additional guidance is expected on the procedures for obtaining IRS approval, but the preamble indicates that it will likely require individuals with over \$250,000 in compensation to (1) indicate the alternative method and explain why it is better, and (2) compare the alternative method with the general time-based rule or fringe benefit rule. Presumably, employers will be able to seek guidance on behalf of similarly situated employees.

Finally, the proposal allows the IRS to assert an alternative method if the compensation (1) is not for a specific time period, or (2) constitutes in substance a fringe benefit, if the alternative basis is more reasonable than the employee's method. IRS can also issue rulings or other pronouncements requiring a specific alternative sourcing rule be used.

The IRS has requested comments by November 4, including whether an alternative basis for multi-year compensation is appropriate or other fringe benefits should be identified. Any change that is ultimately made would apply only to tax years

beginning on or after the publication of final regulations.

5. IRS Program Targets Officer Compensation at Some Tax-Exempts

After several informal warnings that such a program was forthcoming, the IRS has formally announced an initiative to scrutinize exempt organizations' compensation practices (IR-2004-106, Aug. 10, 2004). The IRS News Release said that it will be "a new enforcement effort to identify and halt abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers and other insiders." The stated purposes of the initiative are to:

- address the compensation of specific individuals or instances of questionable compensation practices,
- increase awareness of tax issues as organizations set compensation in the future, and
- learn more about the practices organizations are following as they set compensation and report it to the IRS and the public on their annual Form 990 returns.

The IRS expects to contact nearly 2,000 charities and foundations as part of this project, and, according to Commissioner for Tax Exempt and Government Entities Steve Miller, has already contacted about 200 organizations with the project continuing into next year. The IRS will focus on employees whose compensation is "substantial" in relation to the organization's assets and gross receipts, including loans and uses of property.

According to the News Release, the project is currently limited to organizations described in section 501(c)(3) of the Code, which is the exemption provision for a number of large organizations, such as churches, hospitals and universities, as well as organizations that are thought of as purely "charities," (e.g., the Red Cross). However, depending on the success of this project, it could be expanded to other exempt organizations, such as labor organizations and trade associations.

This project bears a broad resemblance to the IRS Executive Compensation Compliance Initiative,

introduced last fall (Qualified Plans 2003-10). That initiative is limited to a few dozen large for-profit corporations, but, according to informal statements by IRS and Treasury officials, has already produced significant results and is likely to be expanded.

6. 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 (Qualified Plans 2003-7). Revenue Procedure 2004-56 supercedes Revenue Procedure 98-41 (Qualified Plans 98-8) 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.

7. Further IRS Guidance on DRC Funding Relief for Certain Plans

In recent Notice 2004-59 (to be published in the September 7 IRS Bulletin), IRS provided additional guidance on defined benefit plans maintained by commercial passenger airlines and steel companies who elect the alternative DRC provided in the Pension Funding Equity Act (Qualified Plans 2004-4). Under that legislation, if during a plan year for which an alternative DRC is elected, a plan is amended to increase benefits, change the rate of accrual, or change the rate at which benefits become nonforfeitable, and such increase or change results in an increase in the liabilities of the plan, the plan's enrolled actuary must file a certification with IRS that the amendment provides for an increase in annual contributions exceeding the increase in annual charges to the funding standard account attributable to the amendment. No certification is required if the amendment is required by a collective bargaining agreement in effect on April 10, 2004.

Among other things, Notice 2004-59 provides guidance on determining whether an amendment is subject to these restrictions (referred to in the Notice as a "restricted amendment"). Generally, an amendment that increases plan liabilities by increasing benefits, changing the rate of accrual, or changing the rate at which benefits become nonforfeitable under the plan is a restricted amendment if it is adopted during a plan year for which an alternative DRC election is in effect. However, if an amendment adopted in an earlier year becomes effective during an alternative DRC election year (such as an amendment providing for a series of benefit increases effective over a period of years), the amendment is considered adopted in the alternative DRC election year and also would be subject to the certification rules.

Annual cost-of-living adjustments to statutory limits (e.g., Code sections 401(a)(17) and 415(b)(1)(A)) are not restricted amendments if they

automatically become effective pursuant to plan terms adopted and effective before the beginning of the plan year for which an alternative DRC election is made.

The plan's enrolled actuary must provide the certification, including a demonstration that annual contributions were increased by the requisite amount, by the due date of the Form 5500 for that plan year. The Notice also provides guidance on determining the amount by which contributions must increase, including a special rule for plan years for which a funding waiver is granted.

We note that the restriction on plan amendments during an alternative DRC election year appears to apply only to the plan for which the alternative DRC election is made. However, it is possible that IRS could apply the restriction to other plans of the employer, as it sometimes does in granting relief under statutory provisions with analogous amendment restrictions (*i.e.*, funding waivers and bankruptcy).

8. IRS Shuts Down Stock Option Sales to Related Parties

The IRS recently finalized regulations addressing arrangements that involve an executive's sale of compensatory stock options to a related party. 69 Fed. Reg. 48392 (Aug. 10, 2004). The regulations adopt temporary rules released slightly more than a year ago (*Qualified Plans 2004-7*). In the regulations (and IRS Notice 2003-47), the IRS states that use of the arrangements does not defer tax for the executive beyond the exercise date, and that the IRS will challenge an executive's claimed deferral.

Under the Code section 83 regulations, an executive normally has to pay tax on nonqualified stock option gains at exercise. Treas. Reg. § 1.83-7(a). However, promoters had devised arrangements intended to defer the tax on the option gains beyond the exercise date. The arrangements involved an executive transferring options to a related party, such as a family member or a family limited partnership in which the executive's family had a substantial interest. In exchange, the executive received a long-term unsecured note. Promoters claimed that the transaction qualified as an arm's length sale of an option, even though the executive effectively retained control over the exercise of the options. Under the Code section 83 regulations applicable to such sales, the promoters claimed, the executive did not have to pay tax until he received payments on the note.

The IRS has now amended the Code section 83 regulations to make clear that a sale of compensatory options to a related person on or after July 2, 2003, will not be recognized as an arm's length sale, and therefore, will not qualify for the special rule applicable to such sales. The amended regulations define "related person" generally by reference to Code sections 267(b) and 707(b)(1), and make clear that the employer and the grantor of an option (if different) will not be considered "related persons" for this purpose.

Attachment