

# QUALIFIED PLANS 2004-11

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### 1. **Restrictive IRS Proposal For "Phased Retirement" Arrangements**

The IRS recently released proposed rules that allow qualified pension plans to adopt a specific type of "phased retirement" program. 69 Fed. Reg. 65108 (Nov. 10, 2004). We summarize these proposed rules below after providing some background information on this important subject.

#### **A. Background**

"Phased retirement" typically refers to the situation where an employee chooses to continue working part-time or other reduced hours after he or she is eligible to retire. Phased retirement advocates point out that many older employees would like to continue working after retirement age because, for example, there is a risk (especially with increasing life expectancies) that they might outlive their retirement savings. However, older workers frequently do not want to work full-time and also want to begin receiving their pensions.

Longstanding pension rules – based on the assumption that retirement is an "all or nothing" proposition – have presented obstacles to this type

of arrangement. In particular, there has been uncertainty on whether or when pension distributions were permitted prior to "normal retirement age" and, if permitted, what rules applied. In addition, the decrease in compensation associated with part-time employment raised cutback-type issues because a pension benefit is typically based on final average compensation – if an employee's compensation decreases in his or her final years of employment, his or her retirement benefit may decrease as well (although some interpret the Code section 411 rules to require that the accrued benefit not be reduced on account of such pay reductions). Finally, various IRS Code rules – such as the 10% tax on certain distributions before age 59½ (Code sec. 72(t)) and the age 59½ in-service distribution restrictions for various tax-favored programs – substantially limit the available options for flexible phased retirement programs.

In 2002, the IRS requested comments on what rules should be provided for phased retirement and current practices in the area ([Qualified Plans 2002-6](#)). The new IRS proposal for "phased retirement" would relax the longstanding prohibition on "in-service" distributions before a pension plan's "normal retirement age" – but only if an elaborate set of requirements is satisfied. Whether this proposed scheme will meet the human resource objectives of

phased retirement advocates remains to be seen and undoubtedly will be the subject of public comments (due by February 8).

The IRS proposal – which may not be relied upon until after final rules are published – would apply only to defined benefit plans and money purchase pension plans. As noted in the Preamble, many other types of qualified plans, such as profit sharing plans, may permit early distributions under current rules, and 403(b) plans may provide for payout of an active employee's account at 59½ (although section 457 plans generally must defer distributions until "retirement").

The IRS fashioned its proposal around the "magic" age of 59½ – when certain restrictions on in-service distributions and the 10% penalty tax drop off – to avoid potential confusion and unexpected consequences. The age 59½ requirement thus further limits the usefulness of the proposal – although IRS and Treasury cannot be faulted for the current structure of the Code rules.

We note also that, although governmental employers have been keenly interested in phased retirement programs, many of the requirements noted in the IRS proposal – such as nondiscrimination testing, anti-cutback restrictions and spousal consent rules – typically do not apply to governmental plans. Because the rules for phased retirement would be contained in a generally applicable set of qualified plan rules, it is unclear whether governmental phased retirement programs would somehow have to meet all of these private plan requirements. We doubt that such a result was intended, but clarification would be extremely helpful.

## **B. Partial Distributions Permitted**

The proposed rules indicate IRS acceptance of the basic concept of "dual status" employees, *i.e.*, employees who are partially retired and partially active. They would allow a dual status employee to receive a pro-rata share of pension benefits, based on how much the employee has reduced his or her hours of work. To qualify for phased retirement benefits, however, the employee must have been –

- a full-time employee before entering phased retirement,
- eligible to receive pension benefits, and

- the employee's work schedule must be reduced pursuant to a "bona fide phased retirement program."

This pro-rata share is referred to as the "phased retirement benefit."

With one important exception, any early retirement benefit, retirement-type subsidy and optional form that would be available upon full retirement must be available for the phased retirement benefit. The exception is that the phased retirement benefit cannot be paid in the form of a lump sum or any other form that would be eligible for rollover (*e.g.*, 5 annual installments). In addition to retirement benefits, ancillary benefits may be paid during phased retirement, although the regulations do not specify whether the receipt of ancillary benefits is limited to a pro-rata share.

In some cases, an employee's phased retirement benefit may increase after the start of the phased retirement period. For example, an employee may elect initially to receive less than the full phased retirement benefit to which he or she is entitled based on the reduced work schedule. In this case, the employee may elect an additional phased retirement benefit at a later date. Similarly, an employee may decide to work even fewer hours after beginning phased retirement and thereby become entitled to additional phased retirement benefits. In any case where an employee is paid an additional phased retirement benefit, the additional benefit has a new annuity starting date and, accordingly, new participant and spousal notification and consent requirements apply.

When the employee fully retires, the phased retirement benefit may continue unchanged, or the plan may permit the individual to elect a different form. If a different form is elected, there is a new annuity starting date and, accordingly, new participant and spousal notification and consent requirements apply. Any new form must be equal to the actuarial equivalent of the future phased retirement benefits due under the old form, without offset for the benefits previously paid.

If an employee dies during a phased retirement period, the death benefit is allocated between the phased retirement benefit and the benefit payable at full retirement. This means that the death benefit on the phased retirement benefit will be paid in accordance with the optional form of benefit elected, and the death benefit payable on the remaining benefit will be paid in accordance with the terms of the plan.

### **C. Bona-Fide Phased Retirement Program**

To qualify for phased retirement benefits, an employee's work schedule must be reduced pursuant to a written program that meets the following requirements:

- **Age Limit** – The program may be available only to employees who are at least age 59½. The plan may impose additional restrictions, such as a service requirement (e.g., 15 years) or a requirement that the employee's accrued benefit not be subject to mandatory cash-out under Code section 411(a)(11). The Preamble suggests that the maximum age at which phased retirement is permissible is the plan's normal retirement age, presumably because the full distribution of an eligible employee's benefit is permitted at that time. However, the proposed rules themselves do not appear to include such a maximum age limit, and the provisions regarding annual testing (discussed below) suggest that the phased retirement period may extend after a plan's normal retirement age.
- **Voluntary Participation** – Participation in the program must be voluntary. This requirement is intended to address the age discrimination issue that would arise if employees over a certain age were required to reduce their work schedules.
- **Reduction in Hours** – To qualify for any phased retirement benefit, an eligible employee must agree to reduce his or her full-time work schedule by at least 20%.
- **"Key Employee" Owners Not Eligible** – A 1%- or 5%-owner of the employer (as defined for purposes of Code section 416) may not participate in a bona fide phased retirement program. However, other "key employees" and "highly compensated employees" may be eligible (subject to nondiscrimination requirements).

- **Subsidies Preserved** – As noted above, early retirement benefits, subsidies, etc., must be preserved.
- **Timely Plan Provisions Required** – An example in the proposed rules indicates that a plan amendment for the phased retirement program must be in place before the program becomes effective.

In determining if an employee's work schedule has been reduced at least 20%, the actual hours worked must be compared to the actual hours worked under a full-time schedule. This will present problems for salaried employees whose hours normally are not tracked. The IRS has requested comments on whether some other standard would be more administrable.

### **D. Additional Accruals During Phased Retirement**

During the phased retirement period, the worker must be eligible to participate in the pension plan as if he or she were a full-time employee. In general, this means that he or she must be entitled to the same benefits at retirement as a similarly situated employee who did not elect phased retirement – including full-time compensation (although a portion may be imputed because the employee's compensation was reduced to reflect the reduced schedule). The only exception is that the employee must be credited with a period of service for any year, or partial year, during the phased retirement period that is proportionate to the service he would have received under a full-time schedule. This comparison can be made on the basis of hours worked or compensation paid. For example, if a plan required 2,000 hours of service for a full year of service for benefit accrual purposes, a phased retirement employee who worked only 1,400 hours would be entitled to a service credit equal to .7 years.

When the employee retires, the pension benefit must be equal to the employee's total accrued benefit (including accruals during the phased retirement period), offset by the value of the phased retirement benefits. The Preamble states that the QJSA explanation must disclose the potential for offset, which presumably refers to the QJSA explanation provided in conjunction with the phased retirement benefit. This offset would include the value of any early retirement subsidy associated with the phased retirement benefit, which would, in effect, take away the subsidy already paid. The IRS

has requested comments regarding whether early retirement subsidies should be offset against the normal retirement benefit and, if not, how they should be quantified.

The IRS also requested comments on whether any additional guidance is necessary to coordinate the new phased retirement rules (and their requirements regarding post-phased retirement accruals) with the Code's suspension of benefit rules, or any other post-retirement accrual rules.

### **E. Annual Testing**

On an annual basis, the plan must compare the number of hours worked with the number of hours on which the phased retirement benefit is based to ensure that the worker is still eligible for the phased retirement benefit. If the hours actually worked are "materially greater" than the hours on which the phased retirement benefit was based initially, the benefit must be reduced prospectively to reflect the actual hours. The regulations provide that the hours worked are "materially greater" if they exceed either 133⅓% of the reduced hour work schedule or 90% of the hours that the employee would work under a full-time schedule. If the hours are greater – but not "materially greater" – the employer may (but is not required to) decrease the phased retirement benefit.

The testing may be made on any date selected by the employer and applied in a reasonable and consistent manner. The testing date must be stated in the pension plan. Alternatively, the comparison of actual hours worked to the work schedule may be based on a cumulative period that exceeds 12 months, beginning with the annuity starting date of the phased retirement benefit, or a later date specified in the plan. The IRS has requested comments on whether its testing proposal could be simplified.

Exceptions to this testing requirement apply –

- when the testing date falls within the first 12-month period of phased retirement;
- if the employee is within 3 months of attaining normal retirement age (and for later periods);
- if the employee has entered into an agreement whereby he or she will retire within 2 years and the employee so retires;

- where the amount of compensation paid to an employee during phased retirement does not exceed the employee's full-time compensation, multiplied by the percentage of full-time employment worked during phased retirement employment.

The last exception to testing could be very useful in the context of salaried employees. For example, if an employee is working a 50% work schedule during phased retirement and his compensation is not greater than 50% of the compensation he or she would receive for full-time employment, no testing would be required. This appears to avoid the necessity of tracking hours entirely, although the requirements for a bona fide phased retirement program seem to require that the 20% reduction in work schedule be based exclusively on hours. One important issue raised by the reduced compensation exception is what elements of compensation are taken into account for this purpose.

Notwithstanding the above exceptions, if the parties agree to increase prospectively the employee's hours prior to normal retirement age, then the effective date of the increase must be treated as a testing date and the phased retirement benefits adjusted accordingly.

### **F. Related Pension Issues**

The regulations touch on many issues pertaining to phased retirement as well as some frequently raised pension issues –

- **In-Service Distributions at Normal Retirement Age** – In addition to providing for phased retirement benefits, the proposed rules clarify that a participant may elect to receive his entire pension benefit when he or she reaches a plan's normal retirement age. The regulations do not establish a normal retirement date for this purpose, but state that it must be an age that is "reasonably representative" of the typical retirement age of the workforce covered by the plan; it must not be "so low as to be a subterfuge to avoid the requirements of section 401(a)." This issue has been getting increased attention of late, as many cash balance plans are using early "normal retirement ages" (see the discussion of the Bank of America case elsewhere in this issue).

- **"Termination and Rehire" Cases** – The regulations do not address the situation where an employee terminates and is subsequently rehired. Nevertheless, the Preamble does state that the IRS does not view a "prearranged termination and rehire" as full retirement. This is not surprising, but it does confirm the prevailing understanding of the issue in the pension community.
  - **Nondiscrimination Testing** – The regulations provide that the availability of a phased retirement benefit is subject to nondiscrimination testing as a "benefit, right, or feature." In general, this appears to mean that the phased retirement program must be available to a "nondiscriminatory coverage" group under the section 410(b) rules, based on who is eligible for the program for the plan year. The IRS seeks comments on whether there are facts and circumstances under which the age and service conditions for a particular employer's phased retirement program should be disregarded in testing or whether the rules should otherwise be modified.
  - **Anti-Cutback Protection** – Once adopted, the phased retirement benefit is subject to anti-cutback protection as an "optional form of benefit." Accordingly, it cannot be eliminated with respect to benefits already accrued, except to the extent permitted by Code section 411(d)(6) or the regulations thereunder.
  - **Participant Election and Spousal Consent** – Both the phased retirement benefit and the subsequent retirement benefit are subject to the participant and spousal notification and consent rules described in Code section 417. For this purpose, each benefit has its own annuity starting date.
  - **Highly Compensated Employees** – An employee who was a highly compensated employee prior to phased retirement must be treated as a highly compensated employee during the period of phased retirement.
  - **Window Benefit** – The proposed rules provide that a phased retirement benefit may be offered as a window benefit, available for a limited period of time. An example in the proposed rules covers a program for employees who retire within a 2-year period.
- ## 2. **Update on Deferred Compensation Legislation**
- On October 22, President Bush signed into law the American Jobs Creation Act of 2004 (the "Act"), which contains far-reaching changes in the federal tax laws that apply to nonqualified deferred compensation plans. The Act adds new section 409A to the Internal Revenue Code ("Code") that applies to "amounts deferred" after 2004. ([Qualified Plans 2004-10](#) included our summary of the Act.)
- The Act directs Treasury and IRS to issue transition guidance within 60 days of enactment (i.e., December 21, 2004) 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 outstanding deferral elections 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. Further, the Conference 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.
- Treasury and IRS staff have been working diligently on the transition guidance and are hoping to get it out before the December 21 deadline. Meanwhile, Treasury staff have been reiterating in public comments that the transition guidance will provide employers with a reasonable period of time in which to adapt their plans to comply with the new rules. Treasury staff also have generally cautioned against taking immediate actions to amend plans before guidance is issued. They have, however, noted that, because the constructive receipt rules under Code section 451 still apply, employers should require that initial deferral elections with respect to amounts otherwise payable in 2005 (e.g., 2004 bonuses) be made before the end of 2004, even if the election may not otherwise meet the new election-timing rules. In this regard, the Conference

Report makes clear that Treasury and IRS have the authority to provide exceptions to the election-timing rules during the transition period with respect to plans coming into compliance with the new rules.

IRS Announcement 2004-96 (Nov. 22, 2004) puts employers on notice that a new Code Y must be added to the Form W-2, Box 12 to report annual deferrals under plans subject to Code section 409A for 2005 and later years. Future guidance should clarify what amounts need to be reported in this manner.

In general, our recommendations to clients have been consistent with Treasury staff comments cautioning against making immediate plan amendments before guidance is issued. We have, however, recommended that employers revise enrollment materials to provide general information to participants about the changes made by the Act. Moreover, we believe that it is very important that employers identify the plans and arrangements that could be impacted by the legislation and begin determining the changes to existing arrangements that new Code section 409A will require.

Our deferred compensation team of attorneys has prepared checklists to assist in determining what changes may be required to your existing SERPs, voluntary deferral and 401(k) mirror plans. Please contact Krys Burgess of our staff (klb@groom.com) if you would like copies of the checklists.

### **3. Proposed IRS Regulations Would Make Major Changes in the 403(b) World**

For many years, IRS guidance on Internal Revenue Code section 403(b) plans ("403(b) plans") has been a hodge-podge of regulations, exam guidelines, revenue rulings and notices dating back to the 60's. Several years ago, the Service began to tackle the process of updating and consolidating most of this guidance into one unified set of regulations reflecting current law. Though delayed for a while, those regulations have now been issued in proposed form (69 Fed. Reg. 67075 (Nov. 16, 2005)), together with a proposed regulation under the controlled group rules of Code section 414(c), and a temporary regulation under Code section 3121 regarding the definition of salary reduction arrangement for purposes of including amounts in FICA wages.

The restatement of the 403(b) rules follows in the footsteps of similar IRS/Treasury efforts – some complete, some still under way – to update and consolidate other major pension regulations, including those under section 457(b) (eligible deferred compensation plans), section 401(k) and the section 415 limits.

The general thrust of the proposed 403(b) regulations is to follow 401(k)-like rules to the extent possible, and to borrow occasionally from the recently finalized 457(b) rules. While this is partly a result of convenience, it also furthers the goal of key tax policymakers to consolidate all tax-favored retirement plans under the largest umbrella – the one covering 401(k) plans – and to help smooth the path for Administration-backed proposed legislation that would effect such a change.

Major changes that would be made by the proposed rules would –

- impose broad written plan document and operational compliance requirements,
- repeal the nondiscrimination safe harbor of IRS Notice 89-23 and impose a set of "controlled group" rules,
- prohibit the use of life insurance (and certain other incidental benefits) in 403(b) arrangements, and
- allow plan terminations (and concurrent distributions) under rules similar to those for 401(k) plans.

The following summary highlights the principal changes being proposed. Comments are requested by February 14, with a public hearing already scheduled for the next day.

#### **A. Plan and Contract Terms**

**Written Plan Requirement** – While a few 403(b) requirements are required by statute to be in the underlying 403(b) contract (a term which in this context includes custodial account agreements and church retirement income accounts) – and ERISA has always imposed a written plan document requirement on 403(b) plans subject to that law – these regulations impose for the first time a requirement under the Code that there be a written plan document that contains all material terms and conditions for eligibility, benefits, limitations and time and form of distribution. In addition, optional

provisions (such as for loans and hardship distributions) must be set forth in the plan. There need not be a single plan document, however; for example, a "wrap document" could supplement an annuity contract that contained certain terms. Of course, the requirement can also be satisfied by complying with plan document rules applicable to qualified plans.

It is not clear that the Service seeks to impose by this requirement a rule similar to the qualified plan (section 401(a)) rule that a failure merely to follow the terms of the plan document, even if the action taken would not be inconsistent with statutory requirements, would cause the plan to fail to be a 403(b) plan. In addition, the preamble to the proposed regulations indicates that, although creating a plan document does not per se convert a salary-reduction-only plan relying on the ERISA exemption of DOL Reg. §2510.3-2(f) into a plan subject to ERISA, there remains the possibility that the employer may undertake responsibilities pursuant to the plan document that may cause loss of the ERISA exemption. The IRS solicits comments on these issues which it promises to share with the DOL.

This new rule (and other aspects of the proposed regulations) may cause non-ERISA 403(b) plan sponsors relying on that regulatory exemption to look at it more closely to determine whether their plans continue to be exempt from ERISA.

#### **Defined Benefit 403(b) Plans Not Permitted**

– The proposed regulations would require that a 403(b) plan be a defined contribution plan, except in the case of a church 403(b)(9) plan in existence on September 3, 1982. With respect to other plans, the preamble provides that a defined benefit plan in existence on the effective date of the regulations that has taken the position, based on a reasonable interpretation of the statute, that it satisfies section 403(b), would not be subject to the defined contribution requirement, but only with respect to pre-effective date accruals (though IRS notes that the plan may alternatively seek to take the position it is a 401(a) plan, if it also meets the 401(a) rules). In addition, the proposed regulation does not appear to provide that State plans grandfathered from the annuity contract requirement for certain plans in existence on May 17, 1982, would also be grandfathered from this defined contribution rule.

**What Has to be in a 403(b) Contract** – The proposed regulations indicate that certain 403(b) provisions must be in the contract, as opposed to the plan document, including:

- nonforfeitability (which the proposed rules would define by reference to the section 411 vesting rules for qualified plans, though, during the initial period the contract is unvested, the contract must at all times satisfy the 403(b) requirements)
- nontransferability (sec. 401(g))
- limit on elective deferrals (sec. 402(g))
- minimum required distribution rules (including the incidental death benefit rule) (sec. 401(a)(9))
- direct rollover rules (sec. 401(a)(31)).

**What Has to be in The Plan** – The proposed regulations indicate that certain other 403(b) provisions must be in the plan document, including:

- nondiscrimination rules
- 415 limits on annual additions.

**Annuity Contracts Treated as Single Contract** – As under current law, all annuity contracts purchased for an individual are treated as a single contract, but contributions in excess of the 415 limits are treated as made to a separate, non-403(b) contract so long as they are separately accounted for. (If not, the entire contract fails to meet 403(b).)

**Exclusive Benefit Requirement** – Although the Code does not refer to an exclusive benefit requirement for 403(b) plans, the proposed regulations add an exclusive benefit requirement for all assets held in 403(b) custodial accounts and retirement income accounts, whether covered by ERISA or not. The proposed regulations do not appear to impose the exclusive benefit rule on annuity contracts.

**Incidental Benefits Restricted** – The proposed regulation permits distributions that satisfy the incidental death benefits rules for 401(a) plans. However, they take a very restrictive approach on the provision of any benefits other than retirement benefits. In particular –

- They would absolutely prohibit the use of term and permanent life insurance and endowment contracts to fund 403(b) programs, even if the premiums are limited under the longstanding

25%/50% tests (subject to a grandfather rule for contracts issued before February 14, 2005). We suspect this reflects a concern with noncompliance with the incidental tests, as well as a strict interpretation of what funding vehicles or investments Code section 403(b) permits. This is likely to cause an uproar in the life insurance community.

- Similarly, the proposed rules would not allow (subject to the same grandfather rule) the provision of health or accident insurance benefits – a practice that was much less frequently used, but nevertheless permitted.

## **B. Eligible Employers**

**Clarification of Dual Governmental And 501(c)(3) Status** – The regulations would clarify that an organization that is both a governmental entity and a 501(c)(3) tax-exempt organization cannot maintain a 401(k) plan, though it can maintain a 403(b) plan. Such dual status governmental (but non-public school) 403(b) plans are typically seen in the case of governmental hospitals which are separately incorporated and have obtained 501(c)(3) approval by the IRS. The preamble notes that the treatment of "tax-exempt charter schools," another potential "dual status" situation, is not addressed.

**Public School Employees** – To participate in a 403(b) program as performing services for a public school, the employee's compensation must be paid by the State (or political subdivision), and a person occupying an elective or appointed public office must have received training in, or be experienced in, the field of education.

**Indian Tribal School Employees** – For purposes of determining whether an individual is an employee performing services for a public school, an Indian tribal government is treated as a State.

## **C. Funding 403(b) Arrangements**

**Timeliness of Contributions** – Similar to the final 457(b) regulations, the proposed 403(b) regulations impose an ERISA-type rule that contributions should be transferred to the insurance company or entity holding the custodial or retirement income account within a period that is no longer than reasonable for the proper administration of the plan, using the example of transferring elective deferrals within 15 business days following the month in which

the amounts would otherwise be paid to the participant. It is not clear whether the use of that example signifies that it is a safe harbor for contributing salary reduction amounts (which is not the view of the DOL under ERISA).

**Grandfather For Certain Self-Insured State and Local Plans** – Rev. Rul. 82-102 clarified that 403(b) plans had to be invested in commercial annuity contracts, but permanently grandfathered certain self-insured state and local government annuity plans in existence on or before May 17, 1982, including for new participants. The proposed regulations continue this grandfather, where (as under prior IRS guidance) (1) benefits under the contract are provided from a separately funded retirement reserve subject to supervision by the State insurance department, or (2) benefits are provided from a fund separate from the fund used to provide statutory benefits under a State retirement system that is part of a State teachers retirement system to purchase benefits that are unrelated to the basic benefits provided under the State retirement system, and the death benefit provided under the contract at no time exceeds the larger of the reserve or the employee's contributions.

**Church Retirement Income Account Plans** – The proposed regulations incorporate a number of provisions for church retirement income account plans under Code section 403(b)(9) previously found only in the legislative history to TEFRA, the 1982 law which created them. Perhaps the most important of these is an "exclusive benefit" rule. The preamble to the regulations provides that this means, for example, that employers may not borrow assets from a church retirement income account. The proposed regulation also clarifies that a church retirement income account will be subject to the 403(b)(1) annuity rules (for example, for distribution restrictions) rather than the 403(b)(7) rules, even though invested in mutual funds.

The proposed regulations also allow a life annuity to be provided from a church retirement income account without purchase of a commercial annuity contract if the distribution has an actuarial present value at the annuity starting date equal to the participant's accumulated benefit, and the plan sponsor guarantees the annuity. Such self-annuitization is common among older church 403(b)(9) plans.

**401(a)(9) Grandfather For Pre-'87 Monies** – As under prior guidance, pre-'87 monies may be grandfathered from the statutory minimum distribution rules, but only if the amount is separately

accounted for. The proposed regulations also indicate that the pre-'87 account balance will cease to be treated as such if it is distributed and rolled over to another 403(b) contract, though it will be preserved if it is directly transferred to another 403(b) contract and separately account for. There is no mention of an age 75 beginning date for the pre-'87 portion (which is reflected in certain private letter rulings).

The regulation preserves the current rule that the required minimum distribution rules must be separately determined for each separate contract, but that distribution required under one 403(b) contract can be satisfied by a distribution from another 403(b) contract.

**Commingling of Assets** – The proposed regulations provide that, to the extent permitted by IRS guidance, assets held in 403(b) custodial accounts and retirement income accounts may be invested in a group trust with trust assets held under a qualified plan or IRA. This follows several private letter rulings issued in the past, and hints at a future solution to the omission of 403(b) in Rev. Rul. 2004-67, the recent update of the IRS' "group trust" ruling.

The proposed regulations also reflect the rule under the legislative history to TEFRA that church retirement income account assets are permitted to be commingled in a common trust fund with amounts devoted exclusively to church purposes (giving as an example a fund from which pension payments can be made), but provides that no assets of the plan sponsor other than retirement income account assets can be combined with custodial account, qualified plan or individual retirement plan assets. It is not clear whether this is intended to restrict practices among church plans, based upon the TEFRA legislative history, of commingling retirement account plan assets with church endowment funds and church 401(a) plans, provided that the amounts belonging to each can be separately accounted for and the plans are subject to the exclusive benefit rule.

**Tax-Exempt Status of Church Retirement Income Account Trust** – The proposed regulations also clarify that a trust holding church retirement income account assets is tax-exempt.

## **D. Contribution Limits**

**What is an Elective Deferral** – The regulations clarify that, for purposes of applying the limit on elective deferrals (sec. 402(g)), an elective deferral does not include a contribution pursuant to a

one-time irrevocable election made on or before an employee's first becoming eligible to participate, or a contribution made as a condition of employment. Under a temporary rule that reflects the Service's longstanding position, FICA taxes, however, apply to all salary reduction contributions, whether elective or nonelective. 69 Fed. Reg. 67054 (Nov. 16, 2004).

**Excess Contributions And Deferrals** – Excess elective deferrals will not result in a 403(b) failure if distributed, with allocable net income, by April 15 of the following year, or another correction method available under the same rules as apply to 401(k) excess deferrals.

**Coordination of Age 50 Catch-Up Contributions And Special 15-Year Catch-Up** – The proposed regulations clarify that if an employee is eligible for both the age 50 catch-up and the special 403(b) catch-up for certain employees with 15 years of service, any catch-up contribution is first counted against the latter catch-up, and to the extent that is exceeded, is treated as age 50 catch-up.

**Years of Service For "Includible Compensation" And 15-Year Catch-Up Rules** – The proposed regulations continue the prior guidance on determining "includible compensation" for the 415 limit of 100% of includible compensation and for determining if an employee has 15 years of service with a qualifying employer for the special 403(b) catch-up rule. This guidance includes aggregating part-time and seasonal service into full years, using the employer's annual work period (e.g., an academic year) and not necessarily the calendar year, and determining a year of service based on common-law employment, not a controlled group basis (except in the case of church plans, which have a special aggregation rule).

**Definition of "Includible Compensation"** – The proposed regulations also follow prior rules on defining includible compensation. The preamble requests comments on whether plan sponsors should be allowed to use a simpler taxable-year based definition such as that under Code section 415(c)(3) (e.g., W-2 compensation), which is usually easier to determine and administer.

**Post-Employment Contributions** – The proposed regulations incorporate the special, favorable rule added by EGTRRA that deems a former employee to have includible compensation for the period through the end of the taxable year of the employee in which he or she ceases to be an employee and for the next 5 taxable years. The regulation applies this rule to section 415 as well,

but only permits nonelective employer contributions. The preamble indicates that post-employment elective contributions are to be addressed in separate guidance, which is also expected to cover 401(k) plans, governmental 457(b) plans and the section 415(c) limits.

**E. Nondiscrimination Rules**

**Repeal of Notice 89-23 Safe Harbor** – The proposed regulations would repeal the nondiscrimination safe harbors of IRS Notice 89-23, and would generally impose the qualified plan nondiscrimination rules on all employer contributions (other than elective deferrals) to 403(b) plans. The Notice 89-23 safe harbors permitted, in some cases, a nonelective contribution for HCEs at a rate of up to 180% of the rate for non-HCEs. (For example, senior staff might receive a 9% contribution while other staff receives 5%.) Many nonprofits, particularly small ones with high turnover, have relied on that guidance, and may have to make changes to their contribution formulas by 2006. In some cases, nonprofit organizations may wish to explore age and service-weighted contribution formulas, but nondiscrimination testing for such tiered formulas can be complex and difficult to pass.

**New "Universal Availability" Testing Rules**

– A "universal availability" rule has long applied to all 403(b) plans with elective deferrals, excluding some church plans, but including plans of governmental employers. The "universal availability" rule requires that, with certain exceptions, all employees normally working more than 20 hours a week must be able to make salary reduction contributions of at least \$200. Lack of guidance on this test, and the dire consequences of error, have tended to cause employers to interpret the test fairly conservatively in the past.

The proposed regulations introduce several new concepts to the "universal availability" rule, many of which are helpful to employers, including:

- an employee will be treated as normally working fewer than 20 hours per week if –
  - for the 12-month period beginning on the date the employee's employment commenced, the employer "reasonably expects" the employee to work fewer than 1000 hours of service, and

- for each plan year ending after the close of that first 12-month period beginning on the date the employee's employment commenced, the employee worked fewer than 1000 hours of service in the preceding 12-month period.

Thus, the regulation appears to provide that seasonal and part-time workers can be excluded, if they aren't expected to work at least 1000 hours of service in the year of hire and don't actually work more than 1000 hours of service in any year (based on anniversaries from date of employment). (The IRS notes that plans subject to ERISA's 1000-hour rules for participation purposes may be subject to additional requirements.)

- The test is performed on a common-law employer basis, not on a controlled group basis. In the case of a State entity, including a political subdivision, this rule is applied on a "common payroll" basis.
- In addition, the proposed rules allow an employer that has historically treated one or more of its various geographically distinct units as separate for employee benefit purposes to treat each unit as a separate organization if the unit is operated independently on a day-to-day basis.

On the negative side, some of the safe-harbor exclusions of Notice 89-23 have been removed from the universal availability rule, including for –

- Employees who make a one-time election to participate in a governmental plan instead of a 403(b) plan.
- Employees covered by a collective bargaining agreement.
- Visiting professors for up to one year under certain circumstances.
- Employees affiliated with a religious order who have taken a vow of poverty.

Comments are requested on whether the universal availability rule should be applied separately to employees covered by a collective bargaining agreement, and whether any of the Notice 89-23 exceptions not carried over in the proposed regulations should be.

**Anti-Conditioning Rule** – The proposed regulations impose a rule similar to the statutory 401(k) rule that rights or benefits under other plans cannot be conditioned directly or indirectly on an employee's participation (or non-participation) in the 403(b) plan. This seems to be overreaching since Code section 403(b) itself does not contain such a rule, and 403(b) elective deferrals themselves are not subject to discrimination testing.

**Controlled Group Rules** – The proposed regulations include new controlled group rules under section 414(c) for entities that are tax-exempt under section 501(a), such as 501(c)(3) organizations. This change represents a major departure from the current IRS position, which is a "reasonable, good faith" interpretation pursuant to IRS Notice 96-64.

The controlled group rules reiterate a standard found in earlier, pre-Notice 96-64 guidance (including Notice 89-23) that common control exists where 80% or more of the directors of one entity are either representatives of or directly or indirectly controlled by the other organization. However, the proposed regulations would also allow permissive aggregation of tax-exempt organizations if they maintain a single plan and the organizations regularly coordinate their day-to-day activities. The proposed regulations include an "anti-abuse" rule.

These controlled group rules will apply for purposes of nondiscrimination testing, section 415, the 15 years of service catch-up election, and the minimum distribution rules. The preamble also asks for comments on whether these rules should be applied to church entities. The proposed controlled group rules do not address governmental entities (though see above for application of a "common payroll" rule for applying the universal availability rule to governmental plans).

## **F. Distributions, Transfers And Exchanges**

**Severance From Employment** – The proposed regulations generally follow the 401(k) rules for determining whether there is severance from employment. They also provide that a severance occurs when an employee ceases to be employed by an eligible employer that maintains the

403(b) plan. Thus, an employee transferring from a tax-exempt parent to a for-profit subsidiary, an employee of a public school transferring to another agency of the State, or a minister employed by a non-501(c)(3) entity ceasing to perform services as a minister but continuing to be employed by the same entity, will all be considered to have severed employment. This rule does not necessarily require distributions, though it will require that 403(b) contributions for the employee stop.

**Plan Termination Permissible** – The proposed regulations announce for the first time that 403(b) plans can be terminated, and that benefits can be distributed upon plan termination. However, this does not apply if another entity in the same controlled group makes contributions to another 403(b) plan under which 2% or more of the employees in the terminated 403(b) plan participate within 12 months before and after the date of plan termination. (This "successor plan" concept is adopted from the 401(k) rules.) To be considered terminated, all accumulated benefits must be distributed as soon as administratively practicable; this can be satisfied by delivery to participants and beneficiaries of fully paid individual annuity contracts.

**Employer Ceasing to be an Eligible Employer** – The proposed regulations provide that, if an employer ceases to be eligible to maintain a 403(b) contract, the plan can either be frozen (*i.e.*, no further contributions made) or terminated.

**Transfers Between Contracts And Plans** – The proposed regulations permit transfers between 403(b) contracts within a plan (and between plans), provided that both plans permit it, and generally reflecting the rules of Rev. Rul. 90-24 that the benefit is not reduced and the transferee contract impose restrictions on distributions no less stringent than those imposed on the transferor. In a significant change (or perhaps clarification) of the prior guidance, transfers by employees and beneficiaries may only be made to 403(b) contracts of the individual's employer. The regulation is vague as to whether the distribution restrictions can be applied only to the amounts transferred (for example, if an amount is transferred from a custodial account to an annuity contract). If a transfer does not constitute a complete transfer of the participant or beneficiary's interest in the 403(b) plan, the transfer must be treated as including a pro-rata portion of the participant's or beneficiary's after-tax contributions. The preamble also notes that additional rules may apply to a transfer to or from a 403(b) arrangement subject to ERISA under Section

208 of ERISA (the counterpart to Code section 414(l)).

**Exchanges** – Contract exchanges under the same plan may be made if conditions similar to the conditions for transfers are met.

**Mergers and Transfers With Non-403(b) Plans Prohibited** – The proposed regulations confirm the IRS position that 403(b) assets may not be merged with, or transferred to or from, other types of tax-favored retirement arrangements (e.g., 401(k) plans, 457 plans, etc.).

**EGTRRA Transfers** – The proposed rules include a "barebones" statement of the EGTRRA rule that permits 403(b) plan transfers to purchase permissive service credit under a governmental defined benefit plan (or to repay a prior cashout under such a plan). The preamble confirms that such a transfer will not violate the general in-service distribution prohibition for elective deferrals and earnings.

#### **G. Effective Dates of Proposed Regulations**

The effective date of the proposed regulations is proposed to be taxable years beginning after December 31, 2005. The proposed regulations cannot be relied upon until published in final form.

Plans maintained pursuant to a collective bargaining agreement that is ratified and in effect when the final regulations are issued are not subject to the regulations until the bargaining agreement terminates, determined without any extensions after the date of the final regulations.

In the case of church plans, the regulations would not apply before the earlier of (1) July 1, 2007, or (2) 60 days following the earliest church convention that occurs after the date of publication of the final regulations.

#### **H. Observations**

The proposed 403(b) regulations are lengthy and complicated – to be expected for a collection, re-thinking and re-writing of over 40 years of accumulated guidance and changes in the law. Some provisions already seem likely to engender controversy – the written plan document requirement, the prohibition on life insurance contracts, and the repeal of Notice 89-23 nondiscrimination safe harbors immediately present themselves.

It will undoubtedly take some time for the full implications of the proposals to be understood. But the overall theme of the proposed regulations is already clear – to make 403(b) plans more like 401(k) plans. This is the case even though many 403(b) plans themselves involve a collection of different 403(b) contracts and accounts that are difficult to oversee in a comprehensive manner and were never intended to be run like a cohesive plan.

We expect many employers and providers to comment on these regulations, and, of course, the Service asks for comments on many questions. It is likely that the regulations will further evolve before being finalized, and that affected parties will clamor for delayed effective dates.

#### **4. IRS Guidance on PFEA Section 415(b) Limits**

The Pension Funding Equity Act of 2004 (PFEA) included a provision temporarily changing the way that defined benefit plan distribution forms subject to Code section 417(e)(3) (for example, lump sums) are converted to a straight life annuity for purposes of applying Code section 415(b) benefit limits (Qualified Plans 2004-4). These changes apply to distributions with annuity starting dates (ASDs) during plan years beginning in 2004 and 2005. In Notice 2004-78 (Nov. 29 IRS Bulletin), the IRS provides guidance on these new rules, including a somewhat complicated transition rule for distributions commencing in 2004. Below, we describe the general PFEA rule, explain the 2004 transition rule, and highlight cutback and design issues addressed in the Notice.

**Background/General PFEA Rule** – Code section 415(b) establishes two basic limits on benefits that can be paid under a defined benefit plan. A participant's annual benefit, expressed as a straight life annuity, may not exceed a specified dollar limit and may not exceed an amount based on the participant's compensation. If a plan provides benefits in a form other than a straight life annuity, the value of that alternative distribution form must be compared to the value of an equivalent straight life annuity, so that the section 415(b) dollar and compensation limits can be adjusted for the alternative distribution form.

Section 415(b) includes rules for comparing an alternative distribution form to a straight life annuity. Basically, the alternative distribution form is converted to an actuarially-equivalent straight life annuity, and then that equivalent straight life annuity is compared to the section 415(b) dollar and

compensation limits. If the equivalent straight life annuity exceeds one of the section 415(b) limits, the amount payable under the alternative distribution form must be reduced by an amount sufficient so that its equivalent straight life annuity no longer exceeds the section 415(b) limits.

Importantly, section 415(b) includes limits on the actuarial assumptions that a plan may use to calculate an actuarially-equivalent straight life annuity. Under the pre-PFEA rules, for a lump sum or other distribution form that is subject to Code section 417(e)(3), a plan's section 415(b) conversion assumptions could be no more favorable for participants than either (i) the plan's assumptions for calculating the alternative distribution form being evaluated, or (ii) the so-called "GATT assumptions." The GATT assumptions consist of an interest rate that is based on the average yield for 30-year Treasury securities as of a specified date preceding the annuity starting date ("ASD") for the distribution, and an IRS-approved mortality table. Focusing on the interest rate limitation, this restriction basically prevents a sponsor from using artificially low interest rates to convert an alternative distribution form to a straight life annuity. Too-low interest rates are a problem (from an IRS perspective), because they result in low equivalent straight life annuities, and low straight life annuities might appear to comply with section 415(b) dollar and compensation limits even though a participant's benefit would, but for the artificially low interest rates, have exceeded the section 415(b) limits.

PFEA changed these assumptions for a 2-year period (pending Congress' taking a fresh look at interest rate issues for pension plans generally for 2006 and later years). For distributions with ASDs during the 2004 and 2005 plan years, a plan's section 415(b) conversion assumptions generally (subject to transition rules described below) may be no more favorable for participants than either (i) the plan's assumptions for calculating the alternative distribution form being evaluated, or (ii) a 5.5% interest rate (rather than the otherwise-applicable GATT interest rate) and GATT mortality assumptions. To the extent the new 5.5% interest rate is higher than the otherwise-applicable GATT interest rate, the PFEA conversion assumptions reduce a participant's qualified plan benefit. Alternatively, to the extent the new 5.5% interest rate is lower than the otherwise-applicable GATT interest rate, the participant's qualified plan benefit, after application of section 415(b) limits, would be higher. These changes do not apply to plans that terminated before April 10, 2004 (when PFEA was enacted).

**PFEA Transition Rule** – Congress anticipated that the new 5.5% interest rate in PFEA might be higher than the otherwise-applicable GATT interest rate (resulting in lower qualified plan benefits for some participants), and added a transition rule to soften the impact. The transition rule allows (but does not require) plan sponsors to calculate equivalent straight life annuities using certain more favorable assumptions than under PFEA, but only for distributions with 2004 ASDs.

The transition rule does not simply allow a sponsor to apply the pre-PFEA conversion rules. Instead, it permits a sponsor to use alternative assumptions that are no more participant-friendly than either the pre-PFEA assumptions that would have applied (but for PFEA) at the time of the 2004 distribution, or the pre-PFEA assumptions that would have applied if the distribution had occurred on the last day of the plan year beginning before January 1, 2004 (e.g., on December 31, 2003, for a calendar year plan). The Notice makes clear that plan terms in place on this hypothetical 2003 distribution date are used to determine the plan and GATT interest rates that would have applied on that date. For example, if, for purposes of calculating lump sum benefits commencing as of December 31, 2003, a plan used 30-year Treasury yields for August 2002, that would be the interest rate used under the transition rule.

**Amendment Timing; Implementation Options** – The Notice makes clear that sponsors have several options for implementing the PFEA rules, including the transition rule for 2004 distributions, and have flexibility as to when to adopt implementing amendments. Specifically, a sponsor can implement, without violating the anti-cutback rule of Code section 411(d)(6):

- the general PFEA rule and the transition rule as described in the Notice,
- the general PFEA rule as described in the Notice, but not the transition rule, or
- the general PFEA rule as described in the Notice and a "reasonable" interpretation of the transition rule (that is no more participant-friendly than the PFEA rules as described in the Notice).

Also, a sponsor can, without violating anti-cutback rules, delay the adoption of implementing amendments until the last day of the first plan year

beginning on or after January 1, 2006 (e.g., December 31, 2006, for a calendar year plan).

Even if a sponsor decides to delay the adoption of implementing amendments, it still must administer the plan, throughout 2004 and 2005, in a manner consistent with the implementing amendments (as ultimately adopted). Accordingly, plan sponsors need to make decisions now about how they will implement the PFEA changes to Code section 415(b) (or review decisions already made), including the effect on any prior 2004 distributions.

## **5. Bank of America Cash Balance Litigation**

Earlier this month, Bank of America disclosed that a class action lawsuit has been filed against its cash balance plan. The lawsuit focuses primarily on two design aspects of the Bank of America Plan: (1) the plan allows participants to direct the "investment" of their cash balance notional account among a variety of investment options, and (2) many participants were allowed to transfer existing balances from the company's 401(k) plans into the cash balance plan. Significantly, this lawsuit was filed in the same court and assigned to the same judge (Judge Murphy in the Southern District of Illinois) who initially ruled against the IBM cash balance plan. The major allegations in the lawsuit are as follows:

- The plan underpaid participants because distributions did not take into account the potential future growth of the cash balance account to age 65. This is the so-called "whipsaw" claim that has been successful against several cash balance plans, including the Xerox plan. The claim alleges that the plan's low normal retirement age of 5 years of service is not legitimate and does not allow the plan to avoid paying lump sum benefits based on the value of the cash balance account projected to a more "normal" retirement age, e.g., age 65.
- The plan violated the anti-cutback rules of Code section 411(d)(6) by permitting the transfer of employees' 401(k) plan balances to the cash balance defined benefit plan. The anti-cutback rules provide that the separate account feature of a defined contribution plan as

a protected feature that cannot be eliminated.

- The plan's cash balance formula violates the age discrimination laws because the rate of accrual is reduced as a participant ages. This is, essentially, the same age discrimination issue addressed in the IBM case (Qualified Plans 2004-10), which is likely to be appealed to the Seventh Circuit.
- Company and plan fiduciaries violated ERISA's fiduciary duty standards with regard to the investment features of the cash balance plan and the implementation of the administration of the 401(k) transfer features of the plan. The plaintiffs allege that the 401(k) transfer feature of the plan was a "scheme to earn arbitrage-like profits" from the transferred 401(k) balances.
- The lawsuit also names PriceWaterhouseCoopers as a defendant for its role in designing and consulting on the plan design. We note that PWC has a similarly-designed cash balance plan that is the subject of a similar lawsuit in the same court.

Because this suit is still in the very early stages of litigation, it is possible that the outcome of the IBM appeal will provide some new direction to Judge Murphy on basic cash balance issues, in particular, those involving age discrimination. However, even after the IBM plan issues are resolved, there will remain a host of unique issues for Judge Murphy to consider with respect to the Bank of America plan.

## **6. IRS Targets Schemes Exploiting Qualified Plan Nondiscrimination Rules**

In an October 22 memorandum to IRS Employee Plans Examinations and Determinations Redesign Directors, Carol Gold, Employee Plans Director, directed agents to take adverse action with respect to certain qualified retirement plans on the grounds that they impermissibly discriminate in favor of highly compensated employees (HCEs). The IRS stated that the targeted plans improperly discriminate in favor of highly compensated employees – even though they appear to satisfy the

IRS's numerical nondiscrimination tests – and directed agents to (1) issue adverse determination letters to plans with designs similar to those identified in the memorandum, and (2) address, on a case-by-case basis, other types of plans that satisfy the numerical tests by using "abusive" hiring practices or plan formulas.

#### **Background of Nondiscrimination Testing**

**Rules.** To better understand this directive, it is helpful to review the background of the agencies' (IRS and Treasury) numerical nondiscrimination tests. Before the agencies issued a series of proposed and final nondiscrimination regulations between May 1990 and September 1993, the IRS applied the Code section 401(a)(4) nondiscrimination rule on a "facts-and-circumstances" basis. Somewhat controversially, the proposed and final nondiscrimination regulations generally moved away from facts-and-circumstances testing in favor of imposing complex, numerical, "bright-line" nondiscrimination testing rules. The agencies stated that the final regulations were "the exclusive means for determining whether a plan satisfies section 401(a)(4)," and that "intent [was] irrelevant." Treas. Reg. § 1.401(a)(4)-1(a).

Despite this "exclusive means" language, the agencies were wary that plan sponsors might satisfy the letter of the numerical nondiscrimination testing rules, while violating their spirit. The agencies sought to retain some leeway to crack down on abusive interpretations and practices in two ways. First, the agencies retained specific authority "in revenue rulings, notices, and other guidance, published in the Internal Revenue Bulletin, [to] provide any additional guidance that may be necessary or appropriate in applying the nondiscrimination requirements of section 401(a)(4)." Treas. Reg. § 1.401(a)(4)-1(d). Second, the final regulations provided that the nondiscrimination rules "must be interpreted in a reasonable manner consistent with the purpose of preventing discrimination in favor of HCEs." Treas. Reg. § 1.401(a)(4)-1(c)(2).

For perhaps the first time since the nondiscrimination regulations were issued more than 10 years ago, the IRS, in its directive, has taken the position that it would be unreasonable to interpret the numerical nondiscrimination tests to permit certain designs and practices.

**Impermissible Designs and Practices.** The IRS directive specifically targets three types of plan designs, and notes that other types of designs also may violate the nondiscrimination rules.

The directive first targets plans that use benefit formulas or hiring practices to provide substantial amounts to HCEs, and severely limited amounts to non-HCEs, by targeting coverage to non-HCEs with short periods of service. Under an IRS example, a defined contribution plan that satisfies nondiscrimination-in-amount requirements on a "cross-tested" basis (i.e., by converting allocations to accruals payable at normal retirement age, and testing those accruals) and has the following characteristics would be treated as violating the nondiscrimination rules even though the plan satisfies the regulations' numerical nondiscrimination tests:

- the plan excludes from coverage "most or all" permanent non-HCEs;
- the plan covers a group of non-HCEs hired temporarily for short periods of time;
- the plan allocates a higher percentage of compensation to the accounts of HCEs than to non-HCEs; and
- the compensation earned by covered non-HCEs is significantly less than the compensation earned by excluded non-HCEs.

This design, the IRS concluded, impermissibly "distorts" the results of the numerical nondiscrimination-in-amounts test by artificially inflating the allocation rates (and cross-tested accrual rates) for covered short-service non-HCEs. Consequently, a sponsor could not reasonably interpret the nondiscrimination rules to permit this kind of design. The same result would apply, the IRS observed, if a plan design inflated allocation rates by instituting a near-the-end-of-the-year entry date rule, and counted as "benefitable compensation" only pay received during a participant's short period of participation.

Second, the directive targets other kinds of designs similar to the foregoing example, but without "one of the enumerated elements." For example, a plan might violate the nondiscrimination rules, even though it allocates benefits to HCEs and non-HCEs using the same percentage-of-compensation allocation formula, if covered non-HCEs are hired for short periods of time and "there is no reasonable business reason for hiring [such non-HCEs] on a short-term basis."

Third, the directive targets plan designs that limit benefits to a select group of HCEs and to the lowest paid non-HCEs, even where there is no questionable practice of hiring short-term non-HCEs. For example, a plan might violate the nondiscrimination rules if:

- the plan covers a group of low-paid non-HCEs (e.g., the minimum number of non-HCEs needed to satisfy Code section 410(b) coverage requirements);
- the plan excludes all higher paid non-HCEs; and
- the plan allocates a higher percentage of compensation to the employer's sole shareholder (the only covered HCE) than to the covered non-HCEs.

Although the IRS's example involves different allocation rates for a covered HCE and covered non-HCEs, the IRS generally appears not to require a "different allocation schedule" design in order for the design to violate the nondiscrimination rules.

Finally, the IRS noted that the directive is not intended as an exhaustive list of ways that a sponsor can unreasonably interpret the nondiscrimination regulations. For example, a design "with similar facts" may violate the nondiscrimination regulations, and the IRS may consider "additional factors" in determining whether a sponsor is reasonably interpreting the nondiscrimination regulations.

**Comments.** We understand the IRS's efforts to stamp out abusive qualified plan designs, especially those that depend on unreasonable hiring and firing practices. However, the IRS' reliance on the "reasonable interpretation" provisions of the nondiscrimination regulations may be misplaced in the absence of questionable hiring practices. Some observers are concerned that the discussion in the memo on plan designs targeting lower paid employees, without regard to hiring practices, could easily be misunderstood by IRS agents and applied broadly to prohibit plan designs that the IRS and plan sponsors have long considered permissible under the nondiscrimination regulations.

To the extent that the IRS has concluded that the numerical nondiscrimination regulations unwisely permit certain abusive schemes – and that it can articulate the differences between abusive and non-abusive schemes – the better approach would be for the agencies to issue additional detailed public

guidance, as contemplated in the regulations, to close down the abusive schemes. If the IRS is uncomfortable generally with an "exclusive" numerical testing approach – suggested by its questioning the viability of plans "with similar facts" or based on unspecified "additional factors" – the agencies should consider proposing changes to the nondiscrimination regulations, with the opportunity for public comment, to implement a more general facts and circumstances approach. In this regard, the agencies followed that approach several years ago when they amended the "cross-testing" nondiscrimination rules to tighten certain eligibility requirements (Qualified Plans 2001-6).

## **7. Seventh Circuit Backtracks And Refines Partial Termination Analysis**

The Seventh Circuit, in Matz v. Household International Tax Reduction Investment Plan, 2004 WL 2483101 (Nov. 5, 2004), addressed for the third (but perhaps not the last) time a participant's claim that his employer's defined contribution plan experienced a partial termination and, consequently, that he and similarly-situated participants should be vested in their plan benefits.

Back in 2000, the Seventh Circuit concluded, among other things, that it should analyze partial termination claims on a de novo basis (rather than by giving deference to plan administrators), that partial terminations can occur over more than one year, and that both vested and nonvested participants should be taken into account in determining whether a plan has suffered a sufficiently significant reduction in plan participation to trigger a partial termination. The court based its decision to take into account both vested and nonvested participants on the IRS's position in unrelated litigation. (See Qualified Plans 2000-11.)

In 2001, the Supreme Court issued a decision, U.S. v. Mead Corp., that changed the standards for when courts should give deference to agency interpretive rulings, and remanded the Seventh Circuit's 2000 Matz decision. (See Qualified Plans 2001-7.) On remand, and freed from any obligation to defer to the IRS position, the Seventh Circuit concluded that only nonvested participants should be taken into account in determining whether a plan has suffered a significant reduction in plan participation (and affirmed other parts of its earlier 2000 decision).

In its just-issued decision, the Seventh Circuit has backtracked on its decision to count only nonvested participants – reverting to its original position that both vested and nonvested participants should be counted. It also addressed another important partial termination issue – the level of participant reduction required to constitute a partial termination. Finally, the court remanded to the District Court several issues that could affect its partial termination analysis. We elaborate on these points below.

**Including Non-Vested Participants** – The Court began its analysis by considering whether, in calculating a plan's participant reduction percentage, both vested and non-vested participants should be taken into account in determining the denominator of the reduction ratio. The plaintiff argued (and the District Court agreed) that if only non-vested participants are taken into account in determining the percentage reduction in a plan's participation level (the 2001 decision), vested participants should be disregarded both in the numerator and denominator of the reduction fraction. On the other hand, the plan argued that, although only nonvested participants are taken into account in the numerator of the reduction fraction, both vested and nonvested participants should be taken into account in the denominator of the reduction fraction.

The Seventh Circuit rejected both of these approaches. It concluded that excluding vested participants from the reduction fraction's denominator would inappropriately skew the analysis towards finding a partial termination. For example, if a plan has very few nonvested participants, but a sponsor terminates a significant percentage of those participants, these facts would support a partial termination finding even where there are few overall terminations. The court also concluded that including vested participants in the denominator would inappropriately skew the analysis against finding a partial termination. For example, unless a plan has a high percentage of nonvested participants, even a large force reduction that includes a lot of nonvested participants will yield a low percentage of terminated nonvested participants as compared to all participants.

After rejecting both of these measurement approaches – the only approaches available where a court takes into account only terminated non-vested participants in calculating a reduction percentage – the court found itself "drawn back to the IRS's position" described in its 2000 decision, *i.e.*, to take into account both vested and nonvested terminated participants in determining a plan's

participant reduction percentage. The court reached this decision not because the IRS's litigation position was entitled to deference, but because "having toyed with the alternatives" it was the best approach available. The court also said it "respect[ed] the IRS's experience in formulating tax rules."

**20% Rebuttable Presumption** – The court also established a rebuttable presumption that a 20-percent-or-greater reduction in plan participants constitutes a partial termination (and that a smaller reduction does not). This is similar to the IRS's long-established rule-of-thumb that a 20 percent reduction in plan participants triggers a partial termination.

Significantly, the court's decision also establishes a "generous" 30-percentage-point band – from 10% through 40% – within which "consideration of tax motives or consequences can be used to rebut the [20%] presumption." For participant reduction percentages below 10%, the reduction is conclusively presumed not to constitute a partial termination. For participant reduction percentages between 10 and 20%, the reduction is presumed not to trigger a partial termination, but the IRS or a participant can rebut this presumption by demonstrating that a desire for favorable tax consequences motivated the plan sponsor. Similarly, for participant reduction percentages over 40%, the reduction is conclusively presumed to constitute a partial termination. However, for reduction percentages between 20 and 40%, a plan can rebut the partial termination presumption by showing that a desire for favorable tax consequences did not motivate the sponsor in making force reductions.

**Open Issues** – The Seventh Circuit considered, but remanded to the district court for analysis and decision, these other questions:

- Were the terminations that occurred over a 20-month period in fact sufficiently related to justify treating them like a single termination for partial termination purposes?
- Were any participants who appeared to have terminated voluntarily, in fact constructively discharged?
- Should terminations of participants employed by controlled-group entities affected by an identified corporate event, or of all participants employed by

any controlled-group entity, be taken into account?

- Should individuals who became vested during (or after) the period during which a partial termination potentially occurred be treated as vested participants, or as non-vested participants? (It is not clear why this distinction matters, in light of the court's return to the IRS position that both vested and nonvested terminated participants are taken into account for partial termination purposes.)

We suspect that, after the district court addresses these outstanding partial termination issues, its decision may again be appealed to the Seventh Circuit to address the remaining issues.