

QUALIFIED PLANS 2007-9

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1. **IRS Provides Limited Relief from Section 409A Deadline**

On September 10, the IRS issued Notice 2007-78 (the "Notice", Oct. 9 [IRS Bulletin](#)), providing the following transition relief and additional guidance under Code section 409A:

- Extension to December 31, 2008, of the deadline by which plans subject to section 409A must be in full documentary compliance.
- Confirmation that the "good faith" compliance period and other transition relief generally ends on December 31, 2007.
- Guidance addressing issues raised by "good reason" payment triggers and lump sum cash-out features.
- Announcement that the IRS anticipates establishing a limited voluntary compliance program to correct certain unintentional operational violations.

The Notice provides welcome news with regard to the cash-out issue, the addition of section

409A compliant "good reason" payment triggers in change in control agreements and the promise of a voluntary correction program. However, we believe most employers will not find the limited transition relief provided by the Notice to be of much help. By the end of 2007, employers will still need to make many major design decisions for arrangements potentially subject to section 409A, be in strict operational compliance with section 409A, and document the major design decisions made. Nevertheless, some law firms and benefits groups continue to press Treasury for more time so the situation might still change.

A. Background

On April 10, 2007, the IRS issued final regulations under section 409A (the "Final Regulations"). 72 Fed. Reg. 19233 (Apr. 17, 2007). The Final Regulations (summarized in [Qualified Plans 2007-4](#)) address the scope of section 409A, and provide rules for deferral elections and distributions under plans subject to section 409A. Significantly, the Final Regulations did not extend the "transition period" for section 409A compliance (which had been extended most recently by Notice 2006-79) and required full documentary and operational compliance by December 31, 2007.

Following issuance of the Final Regulations, the business and legal communities requested that the IRS extend the transition period so that companies could have more time to make design decisions, have those decisions approved at the appropriate level and then commit the new designs to writing. The Notice is the IRS' response to these requests.

B. What Employers Still Must Do Before 2008

Despite the relief provided in the Notice, employers will still need to take the following actions by the end of 2007.

Make Major Design Decisions – Many employers still need to decide how arrangements will be structured after 2007 to either fit within an exemption from section 409A or to comply with section 409A. For the past few years, the IRS has made transition relief available to facilitate this restructuring. The Notice makes clear that this transition relief period will end on December 31, 2007. Therefore, companies have only until the end of 2007 to take the following actions with respect to amounts potentially subject to section 409A:

- De-link distributions under nonqualified plans that are controlled by distributions under qualified plans (so called "piggyback plans").
- Change the time and/or form of distributions without complying with the subsequent election (the "12-month/5-year rule") and anti-acceleration rules.
- Replace stock options and stock appreciation rights (SARs) that are subject to section 409A (e.g., discounted options) with exempt options or SARs or revise them to provide section 409A compliant fixed payment terms.

Be In Strict Operational Compliance – Notice 2007-78 also makes clear that the "good faith" compliance period, which has also been available the past few years, will end on December 31, 2007. Therefore, strict operational compliance with section 409A and the Final Regulations is required as of January 1, 2008. For arrangements that remain subject to 409A on this date, employers need to be ready to operate the arrangements in accordance with the new 409A-compliant structures created.

Document Basic Distribution Rules – While providing limited relief from the documentary requirements, the Notice still requires that companies document the basic 409A-compliant distribution rules for amounts subject to section 409A before the end of 2007. The documentary requirements and the relief provided by the Notice in this area are described below.

C. Documentary Requirements

The Final Regulations provided the following guidance on the requirement that the material terms of an arrangement subject to section 409A be in writing, effective January 1, 2008:

- The written terms of an arrangement may be in one or more documents.
- At the time an amount is deferred, the plan documents must specify the amount ultimately to be paid (or an objectively determinable, non-discretionary formula to calculate it) and the time and the form of payment.
- The plan documents must set forth the conditions under which deferral elections and subsequent deferral elections may be made.
- Plan documents must contain the six-month delay rule on payment to key employees of public companies by the time an employee becomes subject to the rule.

Retroactive Amendment Period Granted – The Notice provides a "remedial amendment period" for arrangements covered by section 409A. Specifically, the Notice provides that, with the major exception described below, a plan will not violate section 409A merely because it fails to meet the documentary requirements if it is operated in accordance with section 409A and is amended by the end of 2008 to comply retroactively to January 1, 2008. Thus, the Notice allows companies to disregard non-section 409A compliant terms that remain in a plan document (e.g., a "haircut" provision) during 2008 as long as such terms are not used in operation.

A plan is treated as having been amended to comply retroactively to January 1, 2008 if the amended plan contains all of the written provisions required by the Final Regulations and accurately reflects the operation of the plan from January 1,

2008 through the date of amendment, including (i) the terms and conditions under which any initial or subsequent deferral elections were permitted, and (ii) how the operation of the plan met the 409A requirements from January 1, 2008 through the date of the amendment.

Time and Form of Payment Must be Documented Before 2008 – The Notice describes the guidelines under which a plan may be treated as meeting the Final Regulations' requirement to timely document a time and form of payment of an amount deferred under the plan. For amounts that remain unpaid as of January 1, 2008, a plan must designate in writing before January 1, 2008, a 409A-compliant time and form of payment (e.g., lump sum at separation from service). As to amounts to be deferred in 2008, a plan must designate in writing a 409A-compliant time and form of payment by the deadline for electing to defer such amounts under the Final Regulations (e.g., for deferred salary, generally the end of the year before the year in which the salary is earned).

A plan may provide before 2008 that a deferred amount is to be paid upon the earliest or the latest of a number of permissible payment events (e.g., separation from service, death, disability). However, if a payment event is not specified in writing as a potential payment event before 2008, the addition of that payment event (e.g., change in control) is subject to the anti-acceleration and subsequent deferral rules under the Final Regulations. Similarly, if a payment event is specified in writing before 2008 as a potential payment event, the removal of the payment event after 2007 is also subject to the anti-acceleration and subsequent deferral election rules under the Final Regulations.

Retroactive Adoption of Permissible Payment Event Definitions – While the basic distribution rules for amounts subject to section 409A must be documented by the end of 2007, the Notice provides that definitions for the permissible payment events that are used under a plan in 2008 need not be documented until the end of 2008. For example, any permissible alternatives utilized in determining whether a separation from service or change in control occurred in 2008 need not be documented until the end of 2008.

Time For Making Payments After Event – The Notice also permits employers to fine tune their distribution rules by providing that the following types of changes made in 2008 will not be treated as

a change in the time or form of payment (and therefore not subject to the "12 month/5 year rule"):

- The addition or deletion of a post-event payment provision that meets the requirements of the Final Regulations, and does not affect the taxable year in which the payment will be made (e.g., if a plan provides for a lump sum payment upon death, providing that payment will be made before the end of the year in which death occurs).
- The addition, deletion or modification of a provision that payment will be made during a designated period following a distribution event (e.g., if a plan provides for a lump sum payment upon separation from service, providing that payment will be made within 90 days following separation from service).

Six-Month Delay on Payments to Key Employees – Provided that the six-month delay rule applicable to key employees of public companies is applied properly, a plan will not be treated as failing the documentation requirements as long as: (i) the plan is amended before the end of 2008, retroactive to January 1, 2008, to contain this requirement, and (ii) the amended plan accurately reflects the operation of the plan through the date of the amendment. An employer still must be able to demonstrate that during 2008 the six-month delay was applied to affected payments and that the rules used for identifying key employees was applied consistently to all plans and all employees.

D. "Good Reason" Provisions

Two exemptions from section 409A can apply to severance payments if they are payable only upon involuntary termination (the short-term deferral and the "two times pay" exemptions). The Final Regulations allow terminations on account of "good reason" to be deemed involuntary for purposes of these rules if certain requirements are met. Thus, many employers have considered modifying employment and change in control arrangements that contain good reason payment triggers to meet these requirements. However, IRS personnel have expressed concern as to whether an arrangement may be amended even during the transition period to do so.

The Notice states that such a modification will work if: (i) amounts payable under an arrangement are currently subject to a substantial risk of forfeiture

(e.g., the severance is only payable if a change in control occurs first); and (ii) the modification is made by the end of 2007. Consistent with transition relief rules for 2007, the Notice states that such modifications made in 2007 may not affect amounts that are otherwise payable in 2007.

This is welcome news for employers who still are interested in such modifications, particularly with respect to "double trigger" arrangements that provide severance benefits to executives who terminate for good reason after a change in control. The Notice does not provide any helpful guidance on modifying arrangements that provide for severance upon a good reason termination without an additional condition.

E. Employment Agreements – Substitution Rule

Employers have also worried about the Final Regulation rule that generally provides that amounts payable in "substitution" for amounts subject to section 409A will be subject to section 409A. The Notice provides generally that if an employment agreement provides for payments upon an involuntary termination but the right to those payments is forfeited at the expiration of the agreement, then a similar provision in a new or renewed agreement will not be treated as a substitute for the forfeited right.

F. Predetermined Cash-outs

Many plans contain a provision for a lump sum payment at separation from service (or some other permissible payment event) if the value of a participant's benefit at that date is below a predetermined amount (e.g., \$50,000). The proposed regulations under section 409A made fairly clear that such a provision was compliant. However, the Final Regulations were less clear on this point, and IRS personnel have since questioned whether such a cash-out provision was permissible under 409A.

The Notice states that the IRS has some concerns with this type of provision, but until further notice a company may generally treat such a provision as 409A compliant if (i) the 409A distribution rules are otherwise met, i.e., the cash-out amount is fixed when the distribution rules are established, and (ii) the taxpayer can demonstrate that the provision operated in an objective, nondiscretionary manner and did not effectively provide the employee or employer the ability to

make a late election as to the time and form of payment.

Note that the Final Regulations clearly permit (i) a feature whereby a benefit payable in installments or an annuity will be cashed out in a lump sum if the value of the remaining payments drops below a specified amount at any time, and (ii) an employer to accelerate and pay out in a lump sum a participant's benefit if the value is below the Code section 402(g) limit (\$15,500 for 2007).

G. Anticipated Voluntary Compliance Program

The Notice states that the IRS anticipates issuing guidance in the near future establishing a limited voluntary compliance program under 409A. The program will apply to certain unintentional operational failures to comply that are corrected in the same taxable year in which the operational failure occurred, and will also provide other methods by which certain unintentional operational failures may result in only limited amounts becoming subject to adverse treatment under section 409A. This is also welcome relief for employers and executives who are beginning to realize how difficult strict compliance with section 409A will be. Unfortunately, the Notice is silent on the possibility of the IRS issuing advance rulings on section 409A plans.

H. Restrictions on Certain Trusts and Other Arrangements

Section 409A(b) generally prohibits the following "funding" arrangements for nonqualified deferred compensation plans:

- offshore trusts,
- restricting assets to protect a participants' deferred compensation when the employer's financial health is threatened, and
- transferring assets to a trust (including a typical rabbi trust) to protect a participants' deferred compensation when the employer is in a "restricted period" with respect to a single-employer defined benefit plan.

If these prohibitions are violated, relevant assets are includible in the employee's income and the employee will be liable for the additional section 409A taxes on the resulting income inclusion.

The Notice extends the "good faith" compliance period under section 409A(b) that was provided under prior guidance (Notice 2006-33). That is, until further guidance is issued, companies may continue to rely on a reasonable, good faith interpretation of section 409A(b) to determine whether the use of a trust or other funding arrangement causes a problem. However, the Notice emphasizes that prior transition relief under these rules for "grace period assets" (i.e., assets that were set aside, transferred or restricted under a plan on or before March 21, 2006) will not be extended beyond the end of 2007. Thus, such assets will be subject to inclusion and additional section 409A penalties as of January 1, 2008 if the plan under which such assets were set aside, transferred or restricted is not amended to comply with a reasonable, good faith interpretation of section 409A(b) before the end of 2007.

2. DOL Guidance on Defined Contribution Plan Annuity Selection

The Department of Labor ("DOL") recently issued guidance clarifying the rules for the selection of annuity contracts for defined contribution plans. The guidance consists of an Interim Final Rule amending Interpretive Bulletin 95-1 (IB 95-1) to limit the application of the "safest annuity" standard to defined benefit plans, and a Proposed Rule creating a "safe harbor" under the ERISA fiduciary rules for the selection of annuity providers and contracts for purposes of benefit distributions from individual account plans. 72 Fed. Reg. 52004, 52021 (Sept. 12, 2007).

Background – DOL guidance generally holds plan fiduciaries to the "safest annuity" standard when selecting annuity providers for purposes of plan benefit distributions that transfer liability for benefits promised under the plan to the annuity provider (i.e., the insurance company). In IB 95-1 (Qualified Plans 1995-3), the DOL made clear that the selection of an annuity provider under a defined benefit plan is a fiduciary decision and required plan fiduciaries to obtain the safest annuity available, unless under the circumstances it would be in the interest of the participants and beneficiaries to do otherwise. Advisory Opinion 2002-14A (Qualified Plans 2003-1) specifically applied the principles of IB 95-1 to annuity options offered to participants in defined contribution plans, suggesting that it might be appropriate to consider factors other than safety in some cases. In this regard, DOL stated there that it is the view of the Department that it is appropriate

for the fiduciary of a defined contribution plan in selecting an annuity provider to take into account the costs and benefits to the participant or beneficiary of competing annuity products. Consistent with IB 95-1, however, DOL said a lower cost cannot justify the purchase of an unsafe annuity even when the annuity would pay a higher benefit amount to the participant or beneficiary.

PPA Change and New DOL Guidance –

Section 625 of the Pension Protection Act of 2006 ("PPA") requires DOL to issue final regulations clarifying that, while the selection of an annuity contract as an optional form of distribution from an individual account plan is subject to the ERISA fiduciary standards, the selection is not subject to the safest annuity standard in IB 95-1. The DOL has now issued a Final Interim Rule amending IB 95-1, in accordance with the Congressional mandate, to limit its application to the selection of an annuity provider for a defined benefit plan where the plan intends to transfer liability for benefits to an annuity provider. The Proposed Rule makes clear that, although the safest annuity standard is no longer applicable to individual account plans, plan fiduciaries must still discharge their duties with respect to the plan solely in the interest of participants and beneficiaries under ERISA section 404(a)(1)(A), and act with the care, skill, prudence and diligence that a prudent person would use in accordance with ERISA section 404(a)(1)(B). The Proposed Rule states that plan fiduciaries are deemed to have satisfied the prudence requirements of ERISA if they do all of the following when selecting annuity contracts as distributions options for defined contribution plans:

- engage in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities (using a process free from conflicts of interest and, to the extent feasible, involving consideration of competing providers);
- determine either that the fiduciary had the appropriate expertise to evaluate the potential providers or that advice of a qualified, independent expert was necessary;
- consider information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract and the cost of the annuity contract in relation to the benefits and administrative services to

be provided, and conclude that the selected annuity provider is financially able to make all future payments under the contract and that the cost is reasonable in relation to the benefits and services to be provided; and

- in the case of an annuity provider selected to provide multiple contracts over time, periodically revisit the conclusion that annuity provider is financially able to make all future payments and its costs that are reasonable in relation to the benefits and services provided. (However, the DOL confirmed that a fiduciary need not revisit the appropriateness of a provider with respect to participant's contract after it is issued.)

The Proposed Rule goes on to explain that, when assessing the ability of annuity providers to make all future payments and the costs of an annuity contract in relation to the benefits and administrative services to be provided, plan fiduciaries must consider several criteria:

- the ability of the annuity provider to administer the payment of benefits under the contract;
- the amount and nature of any fees;
- the annuity provider's experience in providing annuities of the type being selected or offered;
- the annuity provider's level of capital surplus and reserves available to make payments;
- the annuity provider's ratings by insurance rating services;
- the structure of the annuity contract and the use of separate accounts to underwrite the provider's benefit obligation;
- the availability and extent of additional protection through state guarantee associations (as described in public and accessible information provided by the guarantee associations and state insurance departments), although if widely known facts call into question the availability of the guarantee, the

fiduciary would be required to take development into account; and

- any other information that the fiduciary knows or should know that may be relevant to the evaluation. DOL specifically noted that a fiduciary must take into account information that, because of "timing," had not yet been incorporated into the above factors. Such "late breaking news" might be a corporate event affecting a provider that is reported in the news media.

The Proposed Rule thus provides a lengthy checklist to help fiduciaries comply with their duties in the selection of annuity providers for distributions from 401(k) and other defined contribution plans. (Of course, plan fiduciaries should be sure to document the steps they followed in doing so.) Whether these guidelines are clear and comforting enough to prompt plan sponsors to add annuity options to their plans remains to be seen. Also, the guidelines may not necessarily be well suited to the selection and review of the "new generation" of annuity options and products that insurers have been developing for the 401(k) market. For example, several new products are more like investment options (e.g., providing for the periodic purchase of annuity segments, guaranteed withdrawal rights, etc.) which may be more appropriately analyzed under the rules for participant-directed investment options (ERISA sec. 404(c)) – or possibly a combination of the two sets of guidelines.

Comments on the Proposed Rule will be accepted by the DOL until November 13.

3. Emerging IRA "Rollover Desk" Issues

Several recent developments draw attention to the operation of financial institution IRA "rollover desks" and similar practices geared to attracting IRA rollovers from qualified retirement plans.

Citigroup Settlement. In June, Citigroup Global Markets entered into a \$15 million settlement with the NASD (now FINRA) to settle allegations that several of its employees held seminars and used misleading and inadequate disclosures to induce over 400 BellSouth employees – most below age 60 – to take lump sum distributions from their retirement plans and roll them over into Citigroup brokerage IRAs. It appears that the settled claims related to alleged violations of securities laws, rather than

ERISA. FINRA's press release can be found at: <http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/PO19240>. A similar recent settlement involved Securities America, Inc. of Omaha, Nebraska, and a group of ExxonMobil employees in Texas.

Principal Class Action Lawsuit. On August 28, 2007, two former participants of 401(k) plans administered by Principal Financial Group ("Principal") filed a class action suit against Principal and its broker/dealer subsidiary, Princor Financial Services ("Princor"), alleging ERISA fiduciary violations. In this lawsuit, styled Young, et al. v. Principal Fin. Group, Inc., et al., Civil Action No. 4:07-CV-386 (S.D. Iowa), plaintiffs allege that Principal sent letters to participants in Principal-managed 401(k) accounts who were nearing retirement age, "urging" them to call Principal about their accounts. Concurrently, Plaintiffs filed a separate lawsuit against Principal and Princor alleging violations of federal securities laws – Young, et al. v. Principal Fin. Group, Inc., et al., Civil Action No. 4:07-CV-387 (S.D. Iowa).

The suit alleges that Principal intentionally misled the plaintiffs into believing that they would be calling Principal's plan administration department when, instead, the number they were given was for sales agents at Princor. Plaintiffs allege that Principal instructed Princor sales agents to encourage plaintiffs and other 401(k) participants not to leave their money in their retirement accounts, but to "roll over" their accounts to Principal IRAs offering "J-Share" class Principal mutual funds. Plaintiffs claim that Princor sales agents were instructed to offer only J-Share class mutual funds, even though Principal allegedly has several classes of less expensive funds available. Plaintiffs claim that Princor sales agents received bonuses and commissions for persuading participants to move their retirement accounts over to Principal IRAs.

The Principal complaint alleges that – like many financial institutions – Principal offers "full service" retirement plans to sponsoring employers, including a menu of mutual funds from which an employer can select funds to be offered to plan participants for investment. According to the complaint, once an employer has made its selections, Principal retains the authority to substitute mutual funds from those selected by the employer and to close funds to new investment. The complaint also alleges that Principal exercised discretion by sending letters urging participants to call Principal about their retirement accounts and by instructing Princor sales agents to encourage

participants to rollover their accounts to Principal-managed IRAs. Plaintiffs contend that these actions by Principal make the companies fiduciaries pursuant to section 3(21)(A)(i) and (iii) of ERISA. In addition, plaintiffs allege that Principal and Princor provide "investment advice" to plans within the meaning of section 3(21)(A)(ii) of ERISA because (1) Principal represents that all the mutual funds on its platform are appropriate for its plan customers; (2) Principal provides investment advice to plan sponsors when it recommends mutual funds on the Principal platform; and (3) Princor recommends that participants rollover their retirement accounts and invest in Principal J-Shares.

Observations. The question of whether a service provider has acquired fiduciary status by creating, offering, and maintaining a menu of investment options has been raised in "401(k) fee" lawsuits brought against Principal and other plan service providers. While review of these issues is beyond the scope of this article, a new twist to the new Principal case is the allegation that Principal/Princor acted as fiduciaries by "advising" participants to take plan distributions and roll the proceeds into Principal IRAs. In late 2005, the Department of Labor ("DOL") addressed this issue in an advisory opinion to Deseret Mutual Benefit Administrators. Advisory Opinion No. 2005-23A (Dec. 7, 2005) (Qualified Plans 2005-12). DOL concluded there that, where a person who is not otherwise a fiduciary advises a participant to take an otherwise permissible plan distribution and to invest the proceeds in an IRA, such advice does not make the person a fiduciary. DOL cautioned, however, that the propriety of the non-fiduciary's investment advice may be subject to non-ERISA (e.g., securities) laws and regulations. With respect to an existing plan fiduciary, on the other hand, the DOL indicated that if the fiduciary were to advise participants to roll over their accounts to an IRA, the advice would be subject to ERISA's fiduciary provisions and could involve self-dealing.

The reasoning behind the Deseret Advisory Opinion remains unclear. The crux of the opinion appears to be that, by itself, advising a participant to take a distribution is not a fiduciary act, as it is not advice regarding the management or disposition of plan assets, but relates to a "settlor" decision. At the same time, advising a participant to roll the proceeds over into an IRA cannot be a fiduciary act, as the proceeds are still "outside" the IRA when the recommendation is made (indeed, the IRA may not yet exist). Informally, senior DOL staff members have generally confirmed that this is their reasoning. Nonetheless, those staff members somehow reach a

different conclusion when the person making the recommendations is already a plan fiduciary. Under those circumstances, they indicate that the combined acts of recommending a distribution and recommending the rollover of the distributed assets are tantamount to providing (fiduciary) advice as to the investment of plan assets (notwithstanding the fact that they will cease to be plan assets before the investment occurs). In other words, an otherwise non-fiduciary act somehow can be "converted" into a fiduciary act merely because it is performed by a fiduciary. Beneath the surface, DOL appears to be reluctant to let a fiduciary take advantage of its position of authority to "mislead" participants into believing that it looking out for their best interests, when it is really making a sales presentation.

We expect this area of the law to develop significantly in the coming years – alongside 401(k) fee, revenue-sharing and similar claims.

4. DOL Rule Would Penalize Company Stock Diversification Notice Failures

The Pension Protection Act of 2006 ("PPA") imposes new diversification rules on public company defined contribution plans that have a matching or 401(k) component with investments in employer stock. First effective in 2007, the new rules require (among other things) that eligible employees be notified of their right to diversify out of employer stock at least 30 days before they first become eligible. Under ERISA section 101(m), DOL may assess penalties of up to \$100 per day for each violation of the notice requirements.

The DOL recently adopted proposed and final rules that would implement the penalty provisions in this area. (These are the same DOL penalties that apply to failures to provide blackout notices and a variety of other disclosures.) The amendments are scheduled to become effective October 9, 2007. 72 Fed. Reg. 44970, 44991 (Aug. 10, 2007).

IRS and DOL guidance in this area to date is contained in IRS Notice 2006-7 and DOL Field Assistance Bulletin 2006-03 (both summarized in Qualified Plans 2006-12). The recently released IRS/Treasury guidance priority list indicates that further substantive guidance on the diversification rules should be forthcoming some time over the next year.

5. Proposed DOL Rules on Multiemployer Plan Disclosures

The Pension Protection Act of 2006 ("PPA") imposes significant new disclosure requirements on multiemployer pension plans, effective for plan years beginning after 2007. In general, new section 101(k)(1) of ERISA requires these plans to provide copies of actuarial, financial and other funding-related information to plan participants, beneficiaries, employee representatives and contributing employers, upon their request, limited to one request per year. Failure to meet these disclosure requirements may be penalized up to \$1,000 per violation.

The DOL recently proposed regulations to implement the new disclosure requirements. 72 Fed. Reg. 52527 (Sept. 14, 2007). The proposal provides a laundry list of documents that may have to be furnished, and allows reasonable charges to be imposed for some (but not all) of them. Comments may be made on or before October 15.

6. IRS Studying "Greater of" Formulas But Court Finds No Backloading

Earlier this year, the IRS stunned much of the defined benefit plan sponsor community by taking the position that cash balance pension plans that contained an alternative, "greater-of" benefit structure would likely fail to satisfy the anti-backloading rules of Code section 411(b). The issue began to arise as the IRS started to process the determination letter applications for the backlog of more than 1,200 cash balance plans it had put on hold since late in 1999. Many of these plans had included a benefit structure that continued to provide benefits under the plan's pre-cash balance benefit formula if such benefits would be greater than the new cash balance benefit formula. Even though both the prior benefit formula and the new cash balance (or other hybrid) formula would independently satisfy the anti-backloading rules, IRS took the position that the year-to-year accrual pattern for a participant whose benefit transitions from one of the formulas to the other may not satisfy the rules. Surprisingly, the IRS position would penalize plan sponsors that chose to adopt participant-friendly transition approaches to the implementation of the cash balance design – instead of simply freezing the plan or imposing long "wearaway" periods. If the IRS position is adopted, these plan sponsors may have to retroactively improve benefits.

In response to substantial objections from the plan sponsor community and from members of Congress, the IRS has temporarily backed off from enforcing its strict interpretation of these rules. However, the IRS has not yet determined how to resolve the issue, and it appears that the determination letter applications for affected plans have again gone into a holding pattern pending final resolution. Andy Zuckerman, Director of IRS Employee Plans Rulings and Agreements, was recently reported as indicating that IRS is "diligently" working on resolving the issue and hopes to have "something out" by the end of the year, but there are no guarantees.

Meanwhile, a federal district court in Illinois considered this exact issue and ruled that multiple, greater-of formulas do not violate the anti-backloading rules. In Wheeler v. Pension Value Plan for Employees of the Boeing Company, 2007 WL 2608875 (S.D. Ill. Sept. 6), the court found that the Boeing Plan's multiple, greater-of benefit formulas satisfy the anti-backloading requirements because each formula independently meets those requirements. The court considered plaintiffs' position that IRS regulations require that the accrued benefits under all of a plan's multiple formulas be "aggregated" in order to determine compliance with the anti-backloading rules. The court found that the regulation was intended to apply to benefits calculated under a sequence of formulas over time and not to greater-of benefit formulas. It held – correctly we think – that the policy of the anti-backloading rules was to prohibit benefit structures designed to provide significant increases in benefit accrual rates based on a participant's increased age and years of service. The court found that the accrual rates of the Boeing Plan's formulas were not tied to distinctions of age and service intended to favor older employees. Because the plan's two formulas were mutually exclusive, the plan would satisfy the backloading restrictions as long as each formula independently met the rules.

Finally, the court also addressed plaintiffs' contention that the IRS had interpreted the relevant longstanding regulation as requiring the aggregation of the annual rates of accrual under the plan's benefit formulas. The court found ample evidence of inconsistency in the enforcement of this position by the IRS, and indicated that "agency interpretations that change without rational explanation or vacillate between positions receive little deference."

Hopefully, the analysis and decision in Boeing will help IRS develop a position that allows them to

approve the many plans that contain "greater-of" benefit formulas.

7. 403(b) Transfer Issues Looming

Although the recently issued final 403(b) regulations are generally effective January 1, 2009, they imposed a September 24, 2007 effective date cutting off the current rules for transfers between 403(b) arrangements under Rev. Rul. 90-24 (Qualified Plans 2007-7). Once the rules are fully effective, an "information-sharing agreement" between the employer and the transferee provider will be required to ensure compliance with many of the 403(b) rules, but the regulations did not expressly impose that requirement on transfers made in the interim. (The proposed rules would have prohibited these transfers altogether.)

At present, there is substantial confusion in the 403(b) community as to whether information-sharing agreements or other employer certifications are effectively required for transfers made after September 24, 2007 – as well as over the status of "orphan" 403(b) accounts (e.g., where the employer is no longer in existence), and grandfathered (i.e., pre-September 24, 2007) 403(b) accounts or annuities (where providers customarily rely on employee certification of matters such as hardship and loan entitlements).

IRS officials have indicated that some guidance on these and related issues may be posted on the EP website in the relatively near future.

8. Proposed Worker Classification Legislation Introduced

As we noted in Qualified Plans 2007-6, Congress has started to focus on worker classification issues, including in recent hearings. On September 13, four Democratic senators introduced the "Independent Contractor Proper Classification Act of 2007" (S. 2044), proposing substantive and procedural changes affecting the classification of employees and independent contractors. The bill would reform the safe harbor provisions in Section 530 of the Revenue Act of 1978 (the "Act"), under which, in general, an employer may treat a worker as an independent contractor for employment tax purposes even though the worker is in fact an employee if the employer has a "reasonable basis" for doing so. The bill would amend section 530 of the Act to tighten its use as follows:

- **Allowance of Reclassifications.** The bill would amend the Act by providing that an individual may not be treated as an independent contractor where the Secretary of the Treasury (the "Secretary") determines that the worker should be treated as an employee, even if the taxpayer otherwise has a "reasonable basis" for doing so.
- **Elimination of "Industry Practice" Safe Harbor.** A "reasonable basis" for treating a worker as an independent contractor exists if the taxpayer reasonably relies on judicial precedent, past IRS audit practice with respect to the taxpayer, or long-standing recognized practice in the industry of which the taxpayer is a member. The bill would eliminate the ability of taxpayers to rely on long-standing industry practice as a reasonable basis for treating a worker as an independent contractor.
- **IRS Regulations and Rulings Allowed.** The Act prohibits the IRS from issuing regulations or revenue rulings (but not private rulings) on employee/independent contractor status for purposes of employment taxes. The bill would eliminate this restriction.
- **Review of Classification Status.** The bill would add new provisions allowing an individual to petition the Secretary for a determination of status for employment tax purposes, and to appeal a determination that such individual is not an employee. (Currently, employers can petition the Tax Court to appeal IRS determinations, but workers can not.) If the Secretary determines that an individual has been misclassified, among other things, the Secretary may conduct an employment tax audit of the taxpayer and inform the DOL of the misclassification. The individual may be entitled to attorneys fees and other costs.

authorize or require information sharing among Treasury and the DOL on worker misclassification cases. The bill also would require employers to notify those individuals hired as independent contractors of the right to seek a status re-determination from the IRS, and would require the DOL to update workplace postings required under the Fair Labor Standards Act to include notice of a worker's right to seek such status re-determinations.

We do not see this legislation moving quickly, although it is possible that some of the proposals could get Finance Committee attention soon. Although not aimed at employee benefits, the potential spillover impact of changes in this area should be apparent and might well prompt further activity.

In addition to the above-mentioned amendments to the Act, the bill would strengthen enforcement activities, and require coordination between IRS and DOL. Specifically, the bill would