

QUALIFIED PLANS 2007-12

Friday, December 21, 2007

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HIGHLIGHTS

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1. **DOL Proposes Major Changes to Plan Service Provider Regulations**

The Department of Labor ("DOL") recently published proposed revisions to its regulations under section 408(b)(2) of ERISA. 72 Fed. Reg. 70988 (Dec. 13, 2007). In addition, the DOL proposed a new class exemption which would relieve plan fiduciaries of liability in connection with a prohibited furnishing of services under ERISA section 406(a)(1)(C) where the new disclosure requirements for service providers are not satisfied. 72 Fed. Reg. 70893 (Dec. 13, 2007). As with the recently-finalized changes to the Form 5500, these proposals are a major part of the DOL's fee disclosure initiative. The proposed regulations and exemption are discussed below. Meanwhile, the issues continue to receive attention in Congress – Senators Harkin (D-Iowa) and Kohl (D-Wis) released their version of an ERISA fee disclosure bill (S. 2473) on the same day.

A. Proposed Regulation Changes

ERISA section 408(b)(2) exempts certain arrangements between plans and service providers that would otherwise be treated as prohibited transactions under ERISA section 406(a)(1)(C). Section 408(b)(2) provides relief from the prohibited

transaction rules for service contracts or arrangements if:

- the arrangements are reasonable;
- the services are necessary for the establishment or operation of the plan; and
- the plan pays no more than reasonable compensation for the services.

With regard to the reasonable arrangement prong of the exemption, ERISA's legislative history indicates that, "It is expected that such arrangements will allow the plan to terminate the services, etc., on a reasonably short notice under the circumstances so the plan will not become locked into an arrangement that may become disadvantageous." The current regulations are consistent with the legislative history in that they provide generally that an arrangement will be reasonable if the plan may terminate it without penalty on reasonably short notice. 29 C.F.R. § 2550.408b-2(c).

The proposed changes to the regulations would add a number of disclosure requirements in order for a contract or arrangement to qualify as a "reasonable arrangement." DOL has taken the position that the responsibilities of plan fiduciaries

include the responsibility to collect the information necessary to evaluate the compensation and potential conflicts of interest of plan service providers. The disclosure requirements in the proposed regulation thus focus on service provider compensation and conflicts of interest.

As proposed, the disclosure requirements would apply to three categories of service providers:

- service providers who are fiduciaries (either under ERISA section 3(21) or under the Investment Advisers Act of 1940);
- service providers who provide or may provide banking, consulting, custodial, insurance, investment advisory, investment management, recordkeeping, securities or other investment brokerage or other third-party administration services; and
- service providers who receive or may receive indirect compensation or fees in connection with providing accounting, actuarial, appraisal, auditing, legal or valuation services to a plan pursuant to a contract or arrangement.

The proposed regulations require that service arrangements be in writing and impose an affirmative obligation on service providers to disclose certain information, including:

- the services to be provided;
- the compensation or fees received by the service provider with respect to each service; and
- the manner of receipt (e.g., direct or indirect) of compensation or fees.

The proposed regulations define "compensation or fees" as money or any other thing of monetary value. Under the proposal, gifts, awards, and trips received by a service provider are considered to be compensation for services provided to the plan and must be disclosed. This treatment is disturbing and is similar to the recently finalized Form 5500 regulations.

Another provision of the proposed regulations that is similar to the recently finalized Form 5500 Schedule C reporting requirements is the rule with respect to "bundled" arrangements. A bundled

service provider must disclose the allocation of compensation or fees that are either a separate charge directly against the plan's investment reflected in the net value of the investment or that are fees set on a transaction basis (such as finder's fees, brokerage commissions, and soft dollars). Compensation under a bundled arrangement that does not fit into these two categories does not have to be unbundled or allocated among the service providers in the bundle.

The proposed rule requires additional disclosures focused on potential conflicts of interest, including:

- whether the service provider will provide services to the plan as a fiduciary;
- any participation or interest the service provider may have in plan transactions;
- any material financial, referral or other relationship that creates or may create a conflict of interest for the service provider;
- whether the service provider will be able to affect its own compensation or fees without prior approval of an independent plan fiduciary; and
- any policies or procedures in place to address potential conflicts of interest.

In contrast to the recently filed Form 5500 Schedule C rule, which requires disclosure on the annual Form 5500 at the end of the plan year, the proposed 408(b)(2) regulations require that a service provider disclose the required information prior to entering into a contract or arrangement. The proposed regulation also requires that the written contract include a representation from the service provider that the required information was in fact disclosed before the parties entered into the agreement.

A number of issues are raised by the proposed revisions to the regulations. For example, the proposal would apparently apply to all current service provider contracts and arrangements, meaning that most current contracts may have to be re-negotiated prior to the effective date of the changes (proposed to be 90 days after the publication of the final rule). In addition, there are a number of arrangements that would qualify as service provider arrangements for the purposes of

the proposed regulations, including brokerage arrangements, which do not typically involve a written contract. Under the proposal, these arrangements would be subject to the "written contract" requirement.

The treatment of gifts, meals and entertainment as compensation under the proposed regulations is also problematic. Meals and entertainment expenses may not in fact be intended as compensation for plan service providers, and it is not clear why such expenditures have been included in the coverage of the proposed regulations. In addition, the revised rule would require that expenses for meals and entertainment be disclosed before the parties enter into the contract, but such expenditures are difficult, if not impossible, to predict.

Finally, while DOL likely has the authority to do so, the proposal does not explicitly amend the rules under section 4975(d)(2) of the Internal Revenue Code ("Code"), which contains the parallel Code exemption to ERISA section 408(b)(2). Thus, it is not clear whether DOL intended non-ERISA plans, such as IRAs and HSAs, to be covered under the proposed rule. In addition, without an amendment to Code section 4975(d)(2), it is not clear that the Code's excise tax provisions would even apply to service providers to ERISA-covered plans who do not meet the requirements of the amended section 408(b)(2) regulation.

B. Proposed Prohibited Transaction Class Exemption

The proposed class exemption provides relief for a plan fiduciary who enters into, extends, or renews a contract with a plan service provider that fails to provide disclosures in compliance with the new regulatory requirements, provided certain conditions are met. It would provide relief under ERISA section 406(a)(1)(C) (the prohibited provision of services), but not section 406(b) (self-dealing), section 406(a)(1)(D) (prohibited transfer or use of plan assets) or section 404 (general fiduciary). The proposed exemption does not provide relief for the service provider involved in the transaction.

The relief provided under the exemption would be available to a plan fiduciary as long as the fiduciary entered into the service arrangement with a reasonable belief that the arrangement met the disclosure requirements and did not know or have reason to know of the failure to disclose at the time it occurred. After discovering the failure, the fiduciary must request the missing information in writing. The

plan fiduciary is also required to determine whether to terminate or continue the arrangement with the service provider. This determination must be made based on the facts and circumstances and consistent with the fiduciary's duties under ERISA section 404(a).

The proposed exemption would place a notification burden on plan sponsors to help the DOL enforce the new disclosure requirements. If the service provider refuses to disclose the requested information or fails to provide the requested information within 90 days, the fiduciary must notify the DOL of the service provider's failure to disclose. The notice provided to the DOL must contain:

- the name of the plan;
- the three digit plan number used in the plan's annual report;
- identifying information for the plan sponsor and the service provider;
- name and contact information for the plan fiduciary;
- description of services provided to the plan;
- description of the information the service provider failed to furnish;
- the date the information was requested in writing; and
- a statement as to whether the service provider continues to provide services to the plan.

As with the proposed regulations, a number of issues arise with respect to the proposed class exemption. For example, the exemption provides relief to plan fiduciaries when a service provider breaches the disclosure requirements and triggers a prohibited transaction involving the plan. However, as the regulations and exemption are currently drafted, the extent of potential liability for both the service provider and the plan fiduciary is unclear. It is also unclear what the liability of the parties would be if the plan fiduciary was aware of a failure to disclose and did not qualify for relief under the class exemption.

C. Effective Date

The DOL requests comments on the proposed amendment to the regulations and the corresponding new class exemption by February 11, 2008, and proposes that the new rule and exemption be effective 90 days after publication of the final rule in the Federal Register. If finalized as proposed, the amended regulations and exemption will place substantial new administrative burdens on both plan sponsors and service providers. At a minimum, the timing of this regulation and exemption should coincide with the effective date of the new Form 5500 regulations (*i.e.*, 2009 plan years).

2. No Pension or Executive Compensation Legislative Changes for 2007!

Plan sponsors and administrators should be pleased to learn that Congress adjourned for the year without making any changes affecting the tax treatment of employee benefits or amending ERISA as it applies to retirement or executive compensation plans. Since ERISA was enacted in 1974, there have been very few years when this has been the case. So we all have a breather with more time to digest the ever mounting piles of guidance on the PPA 2006 changes and the Code section 409A rules.

Although nothing in this area got through Congress in 2007, a variety of legislative changes have passed one house or another – with some bouncing back-and-forth between the House and Senate – so some changes are likely to be made next year and may happen fairly soon after Congress comes back to town. The top 10 subjects for legislative action in 2008 include proposals –

- imposing a cap on annual deferrals under Code section 409A,
- expanding the \$1 million deduction limit under Code section 162(m),
- restricting offshore deferred compensation,
- deferring the effective date of the PPA funding rules for single employer plans,
- making numerous PPA technical corrections,

- creating Roth governmental 457(b) accounts,
- expanding disclosure requirements for fees charged to 401(k) plans,
- providing additional benefits and flexibility to employees called to military duty and their families,
- changing the unrelated business income tax ("UBIT") rules for pension fund investments in hedge funds, and
- beefing up the penalties for delinquent or incorrect information returns.

Exactly what the new year will bring, of course, is impossible to predict, but at least some of the above items are likely to become law.

3. Limited IRS Correction Program Under Code Section 409A

On December 3, the IRS issued Notice 2007-100 (the "Notice") (December 26 IRS Bulletin), which sets forth a limited correction program for unintentional operational failures under Code section 409A and solicits comments on a more expansive correction program. If the requirements of the Notice are met:

- Certain operational failures that are corrected during the year the failure occurs will not result in section 409A violations.
- Certain operational failures that occur in years before 2010 and involve only limited amounts (*e.g.*, \$15,500 or less in 2007/2008) may be corrected within two years. Only the amounts involved in such a failure will be subject to adverse treatment under section 409A.

We summarize the IRS' initial foray in this area below.

A. Background on Section 409A Violations and Penalties

Section 409A provides specific rules for deferral elections and distributions under covered plans. If a violation of these rules occurs with respect to an executive's benefits under a plan, generally all the executive's vested benefits that are subject to 409A under the plan (and any plans that

are required to be aggregated with it) are subject to adverse treatment. Specifically, these amounts are taxed to the executive immediately, and a 20% additional tax is also imposed on the amounts plus interest.

There is no exception for de minimis violations under section 409A. Thus, a violation involving a very small amount (e.g., \$50 too much paid one year) can result in the value of an executive's entire plan benefit being subject to these harsh penalties. Given this dramatic result, employers began requesting some time ago that the IRS establish a correction program similar to its qualified retirement plan correction program (the "EPCRS"). The Notice is the first response to these requests.

B. General Requirements for Correction

Relief under the Notice applies only to the correction of unintentional operational failures under a plan with provisions that satisfy the requirements of section 409A. The Notice does not provide any correction mechanism for plan document provisions that do not comply with section 409A. Among other requirements, the following rules apply for corrections under the new program:

- The employer must take commercially reasonable steps to avoid a recurrence of the failure.
- Correction is not available for intentional or egregious failures, or failures related to an abusive tax avoidance transaction.
- The program is not available for a correction that is not made in the year of the failure if the employee is under audit for the year of the failure.
- The employer satisfies the information and reporting requirements described in section V below.

C. Correction During Same Year

The following unintentional operational failures (regardless of the amount involved) will not be treated as resulting in a section 409A violation if they are corrected during the year in which they occur and certain other requirements are met.

- **Mistake in Carrying Out Deferral Elections.** An employer defers more

or less of an employee's compensation than was elected.

- **Erroneous Payments.** Payment of amounts prior to the year they are scheduled to be paid.
- **Erroneous Payments to Key Employees.** Amounts are mistakenly paid to a key employee during the six-month "waiting period" following the employee's separation from service.
- **Erroneous Deferrals.** Amounts that should have been paid to an employee during a certain year are not paid.
- **Correction of Exercise Price of Stock Option.** An unintentional administrative error results in the exercise price of a stock option (or SAR) being less than the fair market value of the underlying stock on the date of grant.

Correction of these errors typically requires repayment of the amount involved (either by the employee or the employer, as applicable). In some circumstances where corporate "insiders" are involved, additional requirements apply, including the calculation and payment of interest. Correction for early payment or payment during the key employee waiting period is not available if the failure occurs during a year the employer experiences a "substantial financial downturn." A stock option exercise price failure may be corrected before exercise by resetting the exercise price in accordance with the terms of the Notice.

D. Correction of Limited Amounts After Year of Failure

Certain unintentional operational failures may be corrected after the year of the failure, if the failure occurs before 2010, does not involve amounts in excess of the Code section 402(g) limit (\$15,500 for 2007/2008), correction is made by the end of the second year following the year the failure occurred, and certain other requirements in the Notice are met. In these cases, the failure will result in only the amount involved in the failure being subject to immediate taxation and the 20% penalty (rather than all amounts the employee has deferred under the plan and other similar aggregated plans). The failures eligible for such correction include:

- **Failure to Defer/Erroneous Payments.** The accelerated payment of amounts that should have been paid in a later year. No repayment by the employee is required to correct in this case.
- **Erroneous Deferrals.** Failure to pay amounts that should have been paid to an employee during a certain year. Prompt payment by the employer is required.

E. Information and Reporting Requirements

If correcting a failure during the same year, the employer must provide a statement to the IRS in its federal tax return for the year the failure occurs and to each affected employee regarding entitlement to section 409A relief. This statement must include the identification of each affected employee (including his or her "insider" status), the amount and plan involved, a description of the failure, a description of corrective actions taken, and an affirmative statement that such failure is eligible for correction and all requirements have been met.

For failures not corrected in the same year, both the employer and employee must attach a statement prepared by the employer to their federal tax returns for the year the failure is discovered. This statement must contain the same types of information set forth above for same year corrections. In addition, the employer's statement to each affected employee must include an instruction to attach a copy of the statement to the employee's federal tax return.

These requirements are considerably more rigorous than self-correction of qualified plans under EPCRS where, in general, there is no requirement for the employer or the employee to report the correction to the IRS. And the Notice makes clear that any use of the relief under the Notice will be subject to IRS audit, and the taxpayer will have the burden of demonstrating that the requirements for relief were met.

F. Future Correction Program

The IRS is considering a corrections program for certain operational failures discovered after the year of failure beyond the limited relief provided in the Notice. Generally, this program would be limited to failures corrected promptly after discovery (and no later than two years after the date of such failure),

and would limit the amount subject to adverse treatment under section 409A to the amount involved in the operational failure, rather than all amounts deferred under the plan and similar plans. This program will not likely provide rulings, closing agreements, or other formal approvals. The Notice provides the basic framework of limitations and requirements for such a program, which are similar to those for the limited program announced in the Notice, other than the \$15,500 limit on the size of the violation and the 2010 deadline.

The Notice requests comments on the design of this future program by March 3, 2008.

4. PBGC Update

Recent PBGC technical updates concerning reporting under ERISA section 4010, payment of lump sums, and PBGC's maximum guaranteed benefit for purposes of applying benefit restrictions, resolve a few of the many open issues swirling around the Pension Protection Act of 2006 ("PPA"). PBGC also has finalized its premium regulation with no substantive changes from the version proposed earlier this year. 72 Fed. Reg. 71222 (Dec. 17, 2007).

A. Technical Updates

Post-PPA Reporting – PBGC's technical update 07-2 (Nov. 28, 2007) addresses the test for determining who is subject to annual reporting under ERISA section 4010.

Section 4010 of ERISA requires annual reporting of corporate financial and pension plan information to PBGC by employers with pension plans that have not attained certain funded levels. For pre-PPA periods, reporting is required if the aggregate unfunded vested benefits of all defined benefit plans in the controlled group covered by Title IV of ERISA exceeds \$50 million. Unfunded vested benefits for this purpose are determined using the current liability rules in section 412 of the Internal Revenue Code ("Code") (section 302 of ERISA).

PPA replaced the single employer plan funding rules based on current liability with funding rules based on a "funding target attainment percentage" in section 430 of the Code (section 303 of ERISA). PBGC's technical update announces that, for reporting obligations that look back to a pre-PPA year, the pre-PPA standard still applies. The section 4010 reporting obligation for a calendar year plan, for example, is based on a testing date which is the last day of the prior plan year. For the 2008

plan year, the testing date is December 31, 2007, and the pre-PPA standard would apply for determining whether 4010 reporting is required.

Post-PPA Lump Sums – Technical update 07-3 (Dec. 3, 2007), addresses the PPA changes to section 417 of the Code as they relate to determining lump sums under plans that terminate in a standard termination.

Under section 417(e)(3) of the Code and regulations, a lump sum must not be less than the amount that is actuarially equivalent to the life annuity payable to the participant at normal retirement. These amounts are determined using specified interest rates and mortality assumptions. PPA changed the applicable interest rates and mortality table for this purpose for plan years beginning on or after January 1, 2008. PBGC has explained that the pre-PPA interest and mortality assumptions will apply to lump sum payments from plans that terminate in a standard termination with a termination date before the effective date of the changes in the interest rate and mortality table under PPA, even if the lump sum is distributed after the effective date of the interest and mortality changes.

Maximum Guaranteed Benefit for Purposes of Benefit Restrictions – Section 436(d)(3) of the Code (section 206(g)(3) of ERISA) limits the payment of lump sums under plans with an adjusted funding target attainment percentage that is at least 60% but less than 80% if the payment exceeds the lesser of (1) 50% of the amount of the payment if the restriction did not apply or (2) the present value of the participant's maximum guaranteed benefit under section 4022 of ERISA. PBGC announced in technical update 07-4 (Dec. 17, 2007) that it will post on its website a table of maximum guaranteed benefits for use in applying this benefit restriction. The table, found at <http://www.pbgc.gov/practitioners/miscellaneous-tables/pvmg.html>, shows maximum guarantee amounts for ages 25 through 84.

B. Final Premium Regulation

PBGC's regulation on premiums, including the termination premiums imposed under the Deficit Reduction Act of 2005 in connection with certain terminated plans, was finalized without significant change from the proposed regulation (Qualified Plans 2007-2). Major provisions are described below.

Small Plan Cap – Under section 4006 of ERISA, as amended by PPA, for plan years

beginning after 2006, the maximum variable rate premium per participant for a plan maintained by an employer that has 25 or fewer employees on the first day of the plan year is limited to not more than \$5 multiplied by the number of plan participants in the plan at the end of the preceding plan year. For example, if a plan has 20 participants, the variable rate premium for each participant is not more than \$100 (20 × \$5), for a plan maximum of \$2,000. All members of the employer's "controlled group" (generally, trades or businesses directly or indirectly linked by an 80% ownership interest based on vote or value) are aggregated for purposes of determining the number of employees.

Under the premium regulation, "employee" for purposes of applying the small plan cap is defined by reference to Code section 410(b)(1), which addresses minimum coverage requirements for qualification, and without regard to IRC sections 410(b)(3)-(5), which permits exclusion of certain individuals from the employee count.

Termination Premiums – The hefty termination premium of \$1250 per participant applies to certain single-employer plan terminations after December 31, 2005. The only comment PBGC received on the proposed regulation asked PBGC to adopt a facts and circumstances approach in collecting the termination premium and to consider limiting recoveries of the premium to amounts a company can afford to pay and remain in business. Not surprisingly, PBGC rejected this comment, explaining the Congress intended the termination premium to discourage terminations, and the recommended change would undermine that purpose. PBGC noted, however, that it has the authority to compromise claims in appropriate circumstances.

Key elements of the regulations in this area are –

- The regulation clarifies that the effective date of the termination premium is based on the date of plan termination established in section 4048 of ERISA, not the date as of which the plan termination is effectuated by court order or agreement. In situations where the date of plan termination is established retroactively, the due date for payment of the premium runs from the date the termination date is established.

- The termination premium applies to a plan terminated under the "reorganization" distress test described in section 4041(c)(2)(B)(ii) of ERISA, the "non-bankruptcy" distress test described in section 4041(c)(2)(B)(iii) of ERISA, or in an involuntary termination initiated by PBGC under section 4042 of ERISA. No termination premium applies to a plan terminated under the "liquidation" distress test. ERISA § 4041(c)(2)(B)(i). For a contributing sponsor with multiple controlled group members, members may use different distress tests for plan termination. The premium regulation provides that the termination premium applies so long as at least one of the controlled group members uses a distress test other than the liquidation distress test.
- The termination premium is payable with respect to each of the three consecutive 12-month periods beginning with the first month following the month in which the date of termination falls. However, if the plan is terminated in a reorganization distress or involuntary termination during the pendency of a bankruptcy reorganization proceeding under chapter 11 or under similar state law, payment is delayed to the first month following the month in which the date of discharge or dismissal occurs. Under the regulation, this deferral provision applies if at least one member of the controlled group meets the reorganization distress test.
- Unlike late-paid flat rate and variable rate premiums, to which an automatic 1% per month (for self-reported delinquencies) or 5% per month (PBGC audit) penalty applies, penalties will be assessed by PBGC for late-paid termination premiums "based on the facts and circumstances" not to exceed 100% of the premium.

5. Year-End PPA Tidbits

Earlier this month, IRS and DOL released a number of items related to various changes made by the Pension Protection Act of 2006 ("PPA"). We briefly note these items below.

Penalty for Failure to Provide Certain PPA Notices – PPA imposes a penalty of up to \$1,000 per violation for the failure to furnish a variety of notices including –

- notice of funding-based limits (ERISA sec. 101(g)),
- multiemployer plan information and withdrawal liability (ERISA secs. 101(k) and 101(l)), and
- notice of employee rights and obligations under an automatic contribution arrangement (ERISA sec. 514(e)(3)).

The DOL has published proposed rules that include a process for assessing those penalties and for plan administrators to appeal the assessments. 72 Fed. Reg. 71892 (Dec. 19, 2007). Among other things, the regulations make these penalties a personal liability of the plan administrator (which may include the sponsor). The Preamble points out that ERISA plan assets can not be used to pay the penalties.

Extension of PPA Diversification Transition Relief – PPA imposed new diversification rules on plans that hold publicly traded employer stock (Code sec. 401(a)(35)). Notice 2006-107 (Qualified Plans 2006-12) provided limited guidance on the new rules, including transition relief for certain practices that could be prohibited by the new rules. Notice 2008-7 (Jan. 22 IRS Bulletin) extends the limited transition relief – set to expire at the end of 2007 – until final rules go into effect.

We understand that proposed rules in this area – where many questions remain open – are likely to be released early in 2008. Notice 2008-7 states that these rules, when finalized, will not apply to pre-2009 plan years.

\$3,000 Retiree Medical Exclusion Covers Self-Insured Health Plans – The PPA provided an exclusion of up to \$3,000 per year for health insurance premiums paid from tax-favored retirement plans for the benefit of eligible retired public safety officers. Q&A 23 of Notice 2007-7 (Qualified Plans 2007-1) took the position that the exclusion does not apply to premiums for self-insured health plans (which many state and local governments have). Notice 2007-99 (Dec. 24 IRS Bulletin) announces a change in this restrictive position, consistent with pending proposed technical

corrections, so that self-insured plans will be covered.

We note also that plans making these distributions are not required to specially report them on Form 1099-R. Plans can simply report the total plan distributions for the year; the individual should claim the exclusion on his or her Form 1040 (line 16).

6. Delay in ISO/ESPP Reporting to IRS

Under Code section 6039(a), a corporation that transfers stock to an individual pursuant to the exercise of an incentive stock option ("ISO") (Code sec. 422) must provide the individual with a written statement regarding the transfer. Similarly, a corporation must provide a written statement to any individual who transfers shares of stock acquired under an ESPP (Code sec. 423) at a price of between 85 and 100 percent of the value of the stock at grant. The statements are required to be provided by January 31 of the following year.

In 2006, Congress amended Code section 6039 to require employers in these circumstances to also file a return with the IRS "at such time and in such manner, and setting forth such information, as the Secretary may by regulations prescribe," effective for 2007 and later years. Because IRS has not provided any guidance, IRS Notice 2008-8 (Jan. 22 IRS Bulletin) waives the IRS filing obligation for 2007 stock transfers. It indicates that forthcoming regulations are expected to include information similar to that required by the regulations under the individual statement requirements of current law (Treas. Reg. § 1.6039-1), and will be effective retroactively to January 1, 2007. Meanwhile, employees should continue to receive the statements.

7. IRS Throws Cold "Wash" Water on Stock Sale and IRA Repurchase

Rev. Rul. 2008-5 covers a tax strategy that financial advisers may occasionally recommend. Under the strategy, a taxpayer sells personally-owned shares (individual stocks or mutual funds) at a loss, but – if the investment is believed to be a good long-term prospect – the shares are immediately purchased by his or her IRA. The ruling applies the longstanding 30-day "wash sale" rule (Code sec. 1091) to deny the loss.

Under the tax law, an individual taxpayer and the IRA are separate "taxpayers" so the technical basis of the rulings is questionable. The IRS relied on a 70-year old tax case involving a similar transaction between a taxpayer and his wholly-owned corporation as support for its position.

Another potential pitfall of these transactions is whether a prohibited transaction (Code sec. 4975) is involved, i.e., whether the transaction is treated as prohibited sale or exchange between the taxpayer and his IRA. Because indirect transactions may be prohibited, that is a possibility. The downside in this area – i.e., the current taxation of all IRA assets – is much great than denial of the tax loss. The ruling expressly disclaims any intent to address this issue one way or the other.