

# QUALIFIED PLANS 2006-5

Wednesday, May 31, 2006

Page 1

## HIGHLIGHTS

---

1. *Tax Cut Legislation Enacted as Pension Conference Continues to Move Slowly*
  2. *Implications of New Tax Shelter Rules For Plan Investments and Managers*
  3. *New Legislation Facilitates IRA Contributions by Military Personnel*
  4. *IRS Updates the EPCRS Program*
  5. *Department of Energy Freezes Reimbursements For Defined Benefit Plans*
  6. *Key Tax Issues Created By Option "Backdating"*
  7. *Second Circuit Requires Specific SPD Disclosure of Evidentiary Burden*
  8. *California's Unrelated Business Tax Not Preempted*
  9. *Puerto Rico Catches Up*
- 

### **1. Tax Cut Legislation Enacted as Pension Conference Continues to Move Slowly**

---

#### **A. Tax Cut Bill Creates Roth Conversion Window**

---

After a long conference, Congressional leaders passed a budget-related tax cut bill (H.R. 4297, the Tax Increase Prevention and Reconciliation Act) that, among other things, extends the lower tax rates on capital gains and dividend income for two additional years through 2010 (when all of the so-called Bush tax cuts will expire), and provides temporary relief for some taxpayers from the alternative minimum tax. President Bush signed the bill into law on May 17, 2006 (P.L. No. 109-222). A summary of the outcome of key benefit-related issues in the bill follows. Significant changes in the tax shelter rules that also may affect benefit plans or their managers are covered elsewhere in this month's issue.

### **1. Elimination of Income Cap for Roth IRA Conversions**

The tax cut bill was scored at just under the "\$70 billion over five years" cap that Congressional tax-writers had to stay within to protect the measure from a potential filibuster under special budget rules. Thus, the tax-writers had to come up with a number of revenue raisers as offsets for the tax relief provisions, including costs occurring outside the five-year budget window. The largest of these revenue raisers is a provision that would eliminate the income limit on conversions of traditional IRAs to Roth IRAs. This provision, however, is not effective until 2010 because tax-writers needed to raise revenue in the years following 2010 to stay within the \$70 billion cap.

Under current law, taxpayers who hold traditional IRAs can generally convert their account balances to Roth IRAs, but only if their adjusted gross income ("AGI") in the year of conversion does not exceed \$100,000. If traditional IRA amounts are converted to a Roth IRA, taxpayers are required to pay taxes on all untaxed amounts in the year in which the conversion occurs.

Effective for tax years beginning after 2009, the \$100,000 AGI limit would be eliminated, thereby allowing taxpayers with income over this amount to convert their traditional IRA to a Roth IRA. A special rule would allow taxpayers converting in 2010 to pay the resulting tax liability from the conversion ratably in 2011 and 2012, unless the taxpayer affirmatively elects to pay the tax in 2010. Certain tax consequences arise if the amounts converted in 2010 are distributed before 2012. Conversions made after 2010 must be included in income in the taxable year in which the conversion is made.

## **2. Pension Provisions Not Included in the Final Package**

Both the House and Senate versions of the tax cut bill included an extension of the Saver's credit. Originally enacted in EGTRRA, the Saver's credit is set to expire at the end of 2006. The Senate bill would have extended the credit through 2009, while the House bill would have extended it through 2008. Neither proposal was included in the final conference agreement. The House version of the pension reform legislation (H.R. 2830) would make the Saver's credit permanent, but it is unclear whether a permanent or temporary (e.g., through 2010) extension will be included in the final pension reform bill.

Also dropped from the final conference report on the tax bill was a provision that would have allowed IRA owners age 70-1/2 or over to make tax-free IRA distributions to a tax-exempt charity or a "split-interest entity" (i.e., a charitable remainder annuity trust or charitable remainder unitrust, a pooled income fund, or a charitable gift annuity). It is possible that this provision, along with a number of miscellaneous charitable-giving provisions, could be included in the pension conference report as part of a "trailer" tax package (discussed below). Currently, conservative members of Congress, led by Senator Rick Santorum (R-PA), are seeking to expand the tax incentives for charitable giving, while the Chairman of the Senate Finance Committee, Senator Chuck Grassley (R-IA), is attempting to eliminate or limit the use of certain charitable-giving devices as a tax shelter. The politics surrounding charitable giving blur the prospects for whether the IRA provision is included in any final agreement.

As a result of the \$70 billion dollar cap, tax-writers were forced to drop from the final bill provisions that would have extended a number of other popular provisions, including temporary extensions of research and development tax credit, the tax credit for college tuition, and the state sales

tax deduction for states without income tax. Congressional leaders have indicated that these provisions may be attached to the pension reform legislation that is currently in conference.

## **B. Pension Reform Continues to Move Slowly**

Negotiations to reconcile differences between the House and Senate versions of the pension reform legislation (H.R. 2830) continue to move along very slowly. Disagreements over whether to tie plan funding requirements to the plan sponsor's credit rating, the treatment of "credit balances," and whether to place mandates on cash balance plan conversions have contributed to the delay. It does appear, however, that conferees have begun to make significant progress in recent weeks. For example, it appears that the conferees have agreed to provisions providing special relief to plans sponsored by commercial airlines.

Key members and staffers close to the negotiations are now saying that action may take place some time in June, which invariably means that Congressional leaders will target the July 4<sup>th</sup> recess as the next deadline for passing a bill. If a bill is not agreed to by that date, there's been some speculation by key staffers that comprehensive pension reform may not happen at all this year.

Proposals to attach the "trailer" tax items (noted above) to the pension bill may have a couple of significant effects on the negotiations. Doing so may give further urgency to negotiations on the pension reforms, but also may increase the cost of H.R. 2830, and could force the conferees to drop certain high-cost provisions, including a provision to make the employee benefit-related EGTRRA provisions permanent. In addition, significant increases in the bill's cost may subject the pension reforms to the Senate budget rules requiring 60 votes instead of a straight majority of 51 votes.

## **2. Implications of New Tax Shelter Rules For Plan Investments and Managers**

The recently enacted "Tax Increase Prevention and Reconciliation Act of 2005" (H.R. 4297) contains provisions (Act sec. 516, adding new Code sections 4965) meant to curtail the investment by tax-exempt entities in transactions which provide inappropriate tax benefits to taxable entities (also known as a "tax shelter"). The provision adds a new excise tax on the tax-exempt entity and applies a tax

on the individual or entity that approves or otherwise causes the tax-exempt entity to be party to the tax shelter transaction. Most surprising to employee benefit professionals is that the tax applies to certain tax-exempt employee benefit plans, such as voluntary employees' beneficiary associations ("VEBAs"), and to persons managing the investments for an even broader class of employee benefit plans.

The tax shelter transactions covered by the new law are "listed transactions" and "reportable transactions" that are either confidential or have contractual protections. The IRS publishes a list of various transactions that they believe are tax shelters and do not provide the tax benefits that they are promised to taxpayers by those promoting the transaction. These "listed transactions" are currently outlined in IRS Notice 2004-67 and more recent announcements. Under the existing rules, a taxpayer entering into these transactions (or "substantially similar" transactions) was required to disclose on the taxpayer's tax return that the taxpayer had entered into the transaction. The IRS would be on notice that the taxpayer had taken a position on the tax return that the IRS believed was incorrect and the IRS could decide to challenge that tax position. Some of these listed transactions would involve a tax-exempt entity as an accommodation party to the transaction to assist the transaction in achieving the tax results that were being promoted in the tax shelter.

Under this new provision, the tax-exempt entities that participate in these listed transactions would be subject to new excise taxes because of their participation. VEBAs (welfare benefit trusts exempt from tax under Code section 501(c)(9)) that invest in these transactions would be subject to this new excise tax. This tax (generally at the 35% rate, under current rate structure) generally would be based on the tax-exempt organization's net income from the transaction – or on the proceeds that the tax-exempt organization received from entering into the tax shelter transaction – and would apply each year the investment was held. The tax is even greater if the tax-exempt entity knew or had reason to know that this was a tax shelter transaction.

In addition to the tax on certain tax-exempt entities, an entity manager of a tax-exempt organization will be subject to a \$20,000 "tax" for each subject transaction that the organization entered into. Generally, an entity manager is the person who approves or otherwise causes the tax-exempt entity to be a party in the tax shelter transaction. This tax would be imposed without

regard to whether the manager knew or should have known a tax shelter was involved. Significantly, for purposes of the tax on entity managers, tax-exempt organizations include not only VEBAs, but also tax-favored retirement plans (defined benefit and defined contribution plans, including 401(k) plans), 403(a) and (b) plans, governmental 457(b) plans and IRAs, as well as medical savings accounts, education savings accounts and other tax-free savings vehicles). The conference report contains the following explanation of the term "entity manager" as it applies to tax-favored retirement plans –

Except in the case of a fully self-directed plan or other savings arrangement with respect to which a participant or beneficiary decides to invest in the prohibited tax shelter transaction, a participant or beneficiary generally is not an entity manager under the provision. Thus, for example, a participant or beneficiary is not an entity manager merely by reason of choosing among pre-selected investment options (as is typically the case if a qualified retirement plan provides for participant-directed investments). Similarly, if an individual has an IRA and may choose among various mutual funds offered by the IRA trustee, but has no control over the investments held in the mutual funds, the individual is not an entity manager under the provision.

A footnote to the above adds: "Depending on the circumstances, the person who is responsible for determining the pre-selected investment options may be an entity manager under the provision."

Many have expressed concern about the scope of what would be considered a tax shelter transaction and whether a pension fund asset manager could be considered an entity manager subject to the \$20,000 per transaction tax. Particularly troubling is the reference in the statute to confidential transactions and transactions with contractual protections as potentially being tax shelter transactions. Some are concerned that the law may apply to investment contracts that require the asset manager not to enter into transactions where unrelated business taxable income (UBIT) is generated. The Treasury Department and the IRS are instructed to provide guidance on what sort of confidential transactions and transactions with contractual protections would be considered tax

shelter transactions. Based on the Treasury and IRS's prior thinking on tax shelter transactions, it seems likely that they will be concerned with deals where the transaction documentation would require that the parties to the transaction keep the details of the transaction confidential or where the transaction promises tax benefits and gives parties to the transaction some recourse if the promised tax benefits are not achieved. Under those assumptions, the requirement that an asset manager not enter into a transaction where UBIT would be generated hopefully would not be enough to make such a transaction a tax shelter transaction. We understand that the IRS is currently working on a guidance project to implement this new law, so some clarification on this issue should be forthcoming.

In addition to the taxes imposed on the tax shelter transaction, new reporting requirements would apply. The tax-exempt entity involved in the tax shelter transaction will have to disclose the transaction to the IRS. In addition, the taxable entity involved in the transaction must disclose to the tax-exempt entity that this is a tax shelter transaction. The fact that the taxable entity must make this disclosure to the tax-exempt entity may make it easier for tax-exempt entities to understand whether they are entering into a tax shelter transaction in the first place.

This vague new provision adds further complexity to plan asset managers' lives, since the tax penalties apparently apply regardless of whether the tax-exempt entity knew that the transaction was a tax shelter transaction. In any case, asset managers should be wary of entering into transactions where the taxable party to the transaction seems to be using the tax-exempt organization's exempt status as a means of avoiding taxation.

This new provision is generally effective immediately, but no tax applies to income or proceeds received on or before September 15, 2006.

### **3. New Legislation Facilitates IRA Contributions by Military Personnel**

Currently, military combat pay is not taxable. As a result, such non-taxable amounts cannot be contributed to an IRA. Under a new law, however, men and women in the U.S. military may take advantage of retirement saving vehicles just like

civilians, and contribute a portion of their combat pay to an IRA, including combat pay earned in 2004 and 2005.

Under the Heroes Earned Retirement Opportunities Act (H.R. 1499, signed into law on Memorial Day (P.L. No. 109-227)):

- combat pay (which is generally excludible from income under Code section 112) is includible in a soldier's income for purposes of determining the IRA contribution limit. The basic IRA contribution limit is the lesser of \$4,000 in 2006 or 100 percent of the taxpayer's gross income;
- military men and women have until May 29, 2009, to retroactively make 2004 and 2005 IRA contributions based on combat pay, up to the applicable limits for those years; and
- contributions that were otherwise made in 2004 and/or 2005 (albeit incorrectly) do not need to be returned.

### **4. IRS Updates the EPCRS Program**

The IRS has updated the Employee Plans Compliance Resolution System (EPCRS) in Rev. Proc. 2006-27 (May 30 IRS Bulletin). The updated guidance generally carries forward the prior guidance (Rev. Proc. 2003-44, Qualified Plans 2003-6) with a number of helpful changes, described below.

In addition to the revenue procedure, the IRS has posted several related items on its website, including, among other things, (a) a chart showing the changes made by the new revenue procedure, (b) Q&As, (c) a user-friendly version of the revenue procedure, (d) a topical index, (e) a list of the name, address, phone number, and e-mail address of the regional VCP Coordinators, and (f) guidance on abusive transactions that affect a plan's eligibility for EPCRS.

This new guidance is generally effective September 1, 2006. However, the provisions regarding the assembly of the VCP submission, as well as the fee for a nonamender failure discovered in connection with a determination letter request (both discussed below), are effective May 30, 2006. In addition, a plan sponsor may voluntarily apply this revenue procedure beginning May 30, 2006.

As with past guidance, the IRS requests comments on possible future enhancements of the Program. Specifically, it requests comments on the following:

- the appropriate method to correct a failure to provide an eligible employee with the opportunity to make catch-up or Roth contributions;
- in light of the fact that the new Code section 415 regulations will no longer include provisions addressing the correction of excess 415 amounts, the appropriate correction of excess 415 contributions, including whether the option of establishing a 415 suspense account should be retained; and
- whether additional correction methods are needed for plans to take advantage of the fiduciary safe harbor recently issued by the DOL for orphan plans, where the plan is subject to the spousal consent requirement.

We understand that the IRS is also exploring the possibility of (a) instituting a uniform sanction structure for Audit CAP, as well as (b) implementing a system to make sure that a plan sponsor is fulfilling the terms of a compliance statement. These topics might be addressed in future guidance, which we understand the IRS at some point hopes to issue on an annual basis under a uniform revenue procedure number.

#### **A. Availability of Correction by Plan Amendment/Need For Separate DL Filing**

A plan sponsor may correct a plan document or demographic failure, as well as an operational failure, by a retroactive plan amendment under both VCP and Audit CAP. Correction by retroactive plan amendment is also available under SCP, but only to address one of the operational failures specifically listed in Appendix V:

- a failure to comply with the maximum annual compensation limit;
- a hardship distribution which is contrary to the terms of the plan;
- a plan loan which is contrary to the terms of the plan; and

- the provision of benefits to ineligible employees.

Generally, if a VCP submission involves a corrective plan amendment, a separate determination letter application will not be required unless (a) the plan is submitted under VCP during its determination letter filing cycle, in which case, a representative of the IRS has stated informally that the VCP filing will serve as the plan's determination letter filing so that the plan sponsor will have to make only one filing (we understand that the IRS intends to issue clarification on this point); (b) the qualification failure is a "nonamender" failure (defined as the failure to timely adopt a required change in the qualification requirements); or (c) the amendment is made to a terminating plan. Where a determination letter application is not required, the compliance statement will constitute a determination as to the effect of the plan amendment on the plan's status as a qualified plan.

If a plan sponsor using SCP corrects a qualification failure by adopting a plan amendment, the plan sponsor must submit a determination letter application with the IRS during its normal filing cycle and identify the corrective amendment in its cover letter.

Appendix V also describes the required correction method for these failures.

#### **B. Operational Failures**

The IRS has issued new guidance addressing a number of common operational failures.

**Plan Loans** – The new EPCRS includes more options for plan loan failures. Under the prior guidance, the advantage of correcting a plan loan problem under VCP was that any deemed distribution could be reported on Form 1099 for the current year, instead of the year in which the loan should have been defaulted. The new procedure includes this option, but also includes options that permit a plan loan failure to be corrected without the plan loan being defaulted, provided the maximum period for repayment, generally five years, has not expired. The new guidance applies only to plan loan failures where: (a) the loan amount exceeds the amount permissible under Code section 72(p)(2)(A), in which case the participant can repay the excess and reamortize the loan over the remaining repayment period (*i.e.*, a new amortization period does not begin); (b) the amortization period exceeds the 5-year period or "level amortization" requirement, in which case the loan can be reamortized to meet

these requirements; or (c) loan repayments fail to be timely made, in which case the participant can either make a lump sum payment equal to the missed payments, plus interest, and/or the loan may be reamortized over the remaining amortization period. The guidance provides that if the employer is partially responsible for failing to have the loan repayments timely made, for example, by failing to make proper payroll deductions, it would be responsible for the payment of interest.

**Exclusion of Employees** – In order to correct the improper exclusion of an employee from a 401(k) plan, the employer must make a QNEC to the plan. The new guidance changes the manner in which the amount of the QNEC is determined so that it reflects the value of the excluded participant's "lost opportunity" instead of the full value of the contribution. Generally, the QNEC to replace 401(k) contributions equals 50% – instead of 100% – of the appropriate ADP multiplied by the excluded employee's compensation. In the case of after-tax contributions, the value of the lost opportunity is 40%, so that the QNEC to replace after-tax contributions equals 40% of the appropriate ACP multiplied by the employee's compensation. In either case, the QNEC to cover the match is based on the full value of the 401(k) or after-tax contributions, not merely the value of the lost opportunity.

**Spousal Consent** – The new guidance includes an alternative method to correct a failure to obtain spousal consent. Under the prior guidance, if a spouse refuses to consent to a prior distribution, the proper correction was to provide the spouse with an annuity equal to the portion of the QJSA that he or she would have received. This method of correction is still available, but, in addition, the plan may distribute a lump sum payment to the spouse, equal to the present value of the annuity, based on the interest and mortality factors used to calculate lump sums.

### **C. Abusive Tax Avoidance Transactions**

New provisions restrict the availability of EPCRS where a qualification failure is directly or indirectly related to an abusive tax avoidance transaction ("ATAT"). An ATAT is any transaction listed under Reg. section 1.6011-4(b)(2), as well as any other transaction identified as an ATAT on the IRS' website. If the plan is under examination, the definition of an ATAT is expanded to include any transaction that the IRS determines was designed to facilitate the impermissible avoidance of tax. Under

the new VCP filing procedures, the plan sponsor must certify that it has not been a party to an ATAT or give a brief description of any ATAT.

Some examples of ATATs from the IRS' website include:

- a plan's purchase of insurance to provide death benefits that exceed the death benefits provided by the plan so that the employer can claim a large tax deduction (Rev. Rul. 2004-20, Situation 2);
- an abusive 412(i) plan that pays high premiums for life insurance and/or annuity contracts that, if continued, would (absent surrender charges) exceed the amount needed to provide the plan benefits (Rev. Rul. 2004-20, Situation 1); and
- springing cash value insurance contracts, whereby a plan transfers a life insurance contract to a participant where the cash surrender value of the policy is temporarily depressed so that the tax on the distribution is small (Rev. Rul. 2004-21 and Rev. Proc. 2005-25).

The following summarizes the key points relating to the new guidance on ATATs:

- SCP is not available to correct any qualification failure directly or indirectly related to the ATAT.
- If, upon review of a VCP application, the IRS determines that there may have been an ATAT, the submission will be referred to the Employee Plans' Tax Shelter Coordinator. If the Tax Shelter Coordinator determines that the failure is related to the ATAT, VCP will not be available to correct the failure, and the case will be referred to examination. If the Tax Shelter Coordinator determines that the failure is unrelated to the ATAT, the failure can be addressed through the VCP application, but the IRS reserves the right to refer the ATAT for examination.
- If, upon review of a plan during audit, the IRS discovers a qualification failure and also determines that there may have been an ATAT, the matter will be

referred to the Tax Shelter Coordinator. If the Tax Shelter Coordinator determines that the failure relates to the ATAT, or that satisfactory corrective actions have not been taken with regard to the ATAT, the IRS reserves the right to conclude that EPCRS is not available for that failure. If the Tax Shelter Coordinator determines that the failure is unrelated to the ATAT, Audit CAP or SCP would be available.

#### **D. Relief For Small Transactions and Excise Taxes**

Several changes provide helpful relief in common problem areas.

- **Recovery of Small Overpayment** – A plan is no longer required to seek the return of an overpayment of \$100 or less, or notify the affected participant that such overpayment is not eligible for rollover treatment.
- **Small Excess Amounts** – The plan is no longer required to distribute or forfeit an excess amount credited to the participant if the amount is \$100 or less. However, if the excess amount exceeds a statutory limit (e.g., section 415), the participant must be notified that the excess amount, including earnings, is not eligible for favorable tax treatment and is not eligible for rollover.
- **Relief From Certain Excise Taxes** – The new guidance permits a plan sponsor to obtain relief from the excise tax (a) on nondeductible contributions, where the sponsor is required to make a contribution as part of a plan correction, and (b) on the distribution of amounts to meet the ADP or ACP test after 2½ months following the end of the year tested, where the testing was performed in a timely manner, but based on data later determined to be inaccurate. This relief is only available under VCP.

#### **E. Other Changes**

**VCP Application Changes** – The IRS made a number of changes to the format of the VCP application, including –

- **Submission Requirements** – The IRS has included an outline of the manner in which it would like the VCP submission to be organized.
- **Acknowledgement Letter** – A plan sponsor that would like the IRS to acknowledge receipt of a VCP application must now complete and include in the submission a copy of the Acknowledgement Form that is included in the guidance.
- **Streamlined Process for Interim Nonamender Failures** – A streamlined submission procedure has been added for certain interim nonamender failures, including the failure to adopt a good faith EGTRRA amendment, an interim amendment required under the Code 401(a)(9) rules, or an interim amendment required under Rev. Proc. 2005-66, Section 5. It is intended that a plan sponsor can complete this relatively simple form and the IRS will simply stamp it as accepted. The IRS intends that the form also will serve as the compliance statement. (No determination letter application is required because the IRS does not issue determination letters on interim amendments.)

**Fees** – The IRS has established reduced compliance fees in the following circumstances:

- **SEPS and SIMPLE IRAs** – The initial fee for SEPs and SIMPLE IRAs has been reduced from \$500 to \$250. However, the IRS retains discretion to charge a higher fee in appropriate circumstances;
- **MRD Failures** – A flat fee of \$500 will apply if a plan's sole failure is the failure to make minimum required distributions, provided the failure affects no more than 50 employees;
- **Nonamender Schedule** – The IRS has reduced the filing fee for certain nonamender failures. For a nonamender submission involving the failure to adopt a good faith EGTRRA amendment, an amendment under the 401(a)(9) rules, or an interim amendment required under Rev. Proc.

2006-55, Section 5, the fee has been reduced to \$375 for each year in which the nonamender failure existed. In some circumstances, the current fee structure (half of the normal fee if the submission is filed within one year following the expiration of the remedial amendment period, or otherwise the normal fee) may continue to apply.

- **Nonamender Failures Discovered By IRS** – A fee schedule has been added for nonamender failures discovered during a determination letter submission, as well as during a plan audit. For example, if a plan with 1,000 participants failed to amend the plan for EGTRRA or subsequent legislation, the fee would be \$17,500 instead of the relatively low fees described above.

**Orphan Plans** – An orphan plan is a plan whose plan sponsor either (a) no longer exists, (b) cannot be located, (c) is unable to maintain a plan, or (d) has abandoned the plan pursuant to regulations issued by the DOL. The new guidance makes VCP and Audit CAP available to orphan plans, and lists the entities that may act on their behalf: (a) a court appointed representative with authority to terminate the plan, (b) if the plan is under investigation by the DOL, the party determined by the DOL to have accepted responsibility for terminating the plan, or (c) if Title I has never applied to the plan and the plan covered only one participant who was the sole owner of the plan sponsor, the participant's surviving spouse if he or she is the sole beneficiary of the plan. Significantly, the new guidance provides that the IRS may permit less than full correction and waive the submission fee for orphan plans. (It should be noted that a plan that has terminated pursuant to DOL regulations governing the termination of abandoned plans are not treated as orphan plans under EPCRS.)

**Group Submissions** – Several helpful changes have been made to the group submissions procedures:

- Sponsors of pre-approved plans (including volume submitter plans) may submit group submissions to cover plan document, operational, and employer eligibility failures.
- The new guidance makes it clear that a separate fee must be paid for each pre-

approved plan document included in a group submission.

- The list of participating employers may be provided to the IRS during any stage of the submission process. The IRS encourages that the information be provided electronically.
- If a participating employer is notified of an impending Employee Plans audit after the Eligible Organization has filed the group submission, its plan will remain part of the group submission.

## **5. Department of Energy Freezes Reimbursements For Defined Benefit Plans**

On April 27, the Department of Energy ("DOE") announced that it would no longer reimburse the cost of contributions to defined benefit plans on behalf of employees of employers that win DOE contracts. Instead, the DOE stated that it would only reimburse contractors for the cost of contributions to a defined contribution plan (e.g., a Code section 401(k) plan). The DOE's new policy is prospective only. Therefore, the DOE will continue to reimburse contractors for expenses associated with defined benefit plans under current contracts, but effective March 1, 2007, the DOE will only negotiate for the reimbursement of costs associated with defined contribution plans. Currently, DOE has about 33 contractors with about 100,000 employees.

The DOE justified the decision to shift cost reimbursements to defined contribution plans on the basis that the new policy will improve the predictability of contractor benefit costs and mitigate the growth of the DOE's long-term liabilities associated with defined benefit costs. The DOE explained that it has experienced significant fluctuations in outlays for reimbursement of contributions to contractors' defined benefit plans – due to the volatility in accrued liabilities as a result of market conditions, investment choices, and other factors.

The DOE's change in policy met with a firestorm of criticism from members of Congress and the employee benefits community. Most argue that, while Congress is struggling to pass legislation to strengthen the defined benefit plan system, it appears that the Bush Administration, through the DOE, is contributing to the decline of the defined benefit plan. House and Senate Democrats already

have introduced identical bills (H.R. 5362 and S. 2794, the Department of Energy Contractor Employee Equitable Treatment Act of 2006) calling for the withdrawal of the new policy and the reinstatement of benefits if contracts are negotiated under the new policy before the legislation is enacted. The House Appropriations Subcommittee on Energy and Water Development also agreed to add an amendment to the DOE's fiscal 2007 appropriations bill to block the new policy. The flurry of Congressional activity was capped off by two separate letters authored by a group of House and Senate Democrats urging the President to withdraw the DOE's policy.

Chairmen and staff of the Congressional Committees with jurisdiction over pensions have yet to act – stating instead that they need more time to study the reasons behind the decision and its potential impact. As a result, it is unlikely the Democratic proposals to block the new policy (H.R. 5362 and S. 2794) will see any action. An amendment requiring the DOE to withdraw the policy was added to the bill that will fund the DOE's activities in 2007, but the appropriations process is a long and arduous one. Thus, it appears that unless the White House, or the DOE itself, takes any action in response to these efforts, the policy will go into effect unchanged. Whether other US contracting agencies – particularly the Defense Department, which makes the most extensive use of government contractors – will follow suit remains to be seen.

## **6. Key Tax Issues Created By Option "Backdating"**

As widely reported, the Securities and Exchange Commission ("SEC") is investigating whether several companies engaged in "backdating" stock option grants issued to their executives. While the details have not been made clear, the suspicion is that the exercise prices for such options may have been based on the value of the granting company's shares as of some earlier date when the shares were trading at a lower price. The options may have been documented as if they were issued on this earlier date, hence the term "backdating."

The issuance of a stock option with an exercise price below the value of the underlying shares on the date of grant (a "discounted option" or "below market option") may result in accounting charges, securities law disclosure issues and shareholder suits. In addition, discounted options create several potentially significant tax issues for

companies and executives. We briefly summarize these tax issues below.

**Disqualification of ISOs** – Stock options meeting certain requirements under Code section 422 ("Incentive Stock Options" or "ISOs") provide favorable treatment for the option recipients. Specifically, income is not recognized upon exercise of the option (except for AMT purposes) and all gain on the ultimate sale of the option shares may qualify for capital gain treatment.

A discounted option will not qualify for this favorable ISO treatment and will be treated as a nonqualified option. Upon exercise of a nonqualified option, an executive is required to recognize income equal to the "spread" on the option at that time. If an executive mistakenly treated an option as an ISO upon exercise, his income in the year of exercise would be understated.

**New Code Section 409A Rules** – A discounted option will generally subject the recipient to adverse tax consequences under the deferred compensation rules of Code section 409A, unless the option was vested before 2005 and thus exempt. Specifically, the recipient of such an option would be subject to immediate tax on the value of the option when it vests (perhaps based on the spread at that point) plus an additional tax equal to 20 percent of this amount. However, the proposed regulations provide that if the option plan is amended by the end of the section 409A transition period (December 31, 2006) so that the option exercise price is the fair market value of the stock at the time of grant, the option will be considered to be exempt from section 409A during the transition period.

Beginning in 2002, the Sarbanes-Oxley Act of 2002 required that option grants by a public company to its officers had to be reported to the SEC on a Form 4 within two business days. Thus, instances of backdating grants are believed to be limited since the effective date of this change. Because section 409A generally only applies to options that vested after 2004, the number of backdated options potentially subject to section 409A should be limited.

**\$1 Million Deduction Limit** – Code section 162(m) generally limits to \$1 million a publicly-traded company's deduction for compensation paid to each of its top five executives in a single year. However, certain "performance-based compensation" is exempt from the \$1 million limit.

Proceeds received upon exercise of an option will typically qualify as performance-based compensation (and company's proxy statements often indicate this to be the case with their options). However, proceeds from the exercise of a discounted option will not so qualify, and thus, a company's deduction for such amounts may be reduced or eliminated under section 162(m).

## **7. Second Circuit Requires Specific SPD Disclosure of Evidentiary Burden**

In a case of first impression, the Second Circuit recently ruled that the trustees of a multiemployer pension fund did not breach their ERISA fiduciary duties by requiring a participant to submit pay stubs or other evidence supporting his claim to additional pension credits, but held that the plan violated ERISA by not disclosing the policy in its summary plan description ("SPD"). Wilkins v. Mason Tenders Dist. Council Pension Fund, 445 F.3d 572 (Apr. 21, 2006).

**Background** – The plaintiff, Abraham Wilkins, was a member of multiple unions, and worked for fourteen employers in the construction industry over various periods from the 1950s until the 1980s. As a result of his employment, Wilkins was a participant in the Mason Tenders' District Council Pension Fund (the "Fund"). Wilkins filed an application for pension benefits, and the Fund paid him a lump sum benefit of \$429.21, based on pension credits earned in 1962, 1963, and 1965. Although the Fund had records that Wilkins had engaged in covered employment in other years, the earnings in those years were insufficient to qualify for pension credits.

Wilkins claimed that he was owed additional pension benefits based on work he performed that was not detailed in the Fund's records, and submitted his Social Security Administration ("SSA") statement of earnings to support the additional work. The Fund denied Wilkins's claim for additional benefits, stating that it could not determine whether the extra earnings detailed on the SSA statement represented "covered employment" for which he could earn pension benefits. The Fund also advised Wilkins that it had adopted a policy by which participants seeking additional pension credits had to submit pay stubs to establish that the additional work was performed at the union hourly rate – unless the Fund had conducted a random payroll audit of the employer during the relevant period, and the audit records supported the benefits claim. This "Pay Stub Policy" was set down in writing, but was

not incorporated into the Fund's Plan Document or SPD. Wilkins could not produce pay stubs to support his claim for additional benefits, asserting that they had been lost over the years. Since the Fund had not conducted audits of Wilkins's employers for the years in question – and Wilkins could not produce the pay stubs – his initial claim for benefits was denied and similar action was taken on appeal.

Wilkins filed suit, alleging that he was owed additional pension benefits and that the Fund violated its ERISA-based fiduciary duties, by:

- improperly shifting its burden of keeping accurate records to him;
- failing to audit employers' reporting of covered employment;
- not maintaining the records of audits it did conduct; and
- failing to warn or advise participants that they could be called upon to produce evidence proving covered employment.

The district court found that the Fund's undisclosed "Pay Stub Policy" was arbitrary, but noted that, in considering Wilkins's appeal, the Fund was willing to accept other evidence that he had engaged in covered employment that was not reported to the Fund. The court held that the Fund's policy of requiring claimants to prove their entitlement to benefits based on unreported earnings was not arbitrary, and thus upheld the Fund's denial. The court went on to reject Wilkins's challenges to the Fund's audit practices.

**The Second Circuit Decision** – The Second Circuit, like the district court, summarily rejected Wilkins's claims regarding the Fund's audit practices, noting that the Fund had adopted a random audit procedure, and finding that the lack of an audit of Wilkins's employers during the years at issue did not, without more, establish a breach of fiduciary duty. The court went on to reject Wilkins's claim that the Fund failed to maintain adequate records of its audit procedures and audit results.

The Second Circuit agreed with Wilkins, however, that the plan violated ERISA's SPD disclosure provision (ERISA § 102(b)) and the implementing DOL regulations when it failed to include, in the SPD, the Fund's policy requiring participants to produce records of covered

employment in the event of employer underreporting. The DOL regulations provide that an SPD must include a statement identifying "circumstances which may result in disqualification, ineligibility, or denial, loss, forfeiture, suspension, offset, reduction, or recovery (e.g., by exercise of subrogation or reimbursement rights) of any benefits that a participant or beneficiary might otherwise reasonably expect the plan to provide on the basis of the description of benefits required by [the regulations]." 29 C.F.R. § 2520.102-3(l). According to the court, "[i]t seems to us obvious that the Policy, by erecting an additional, mandatory prerequisite to the receipt of promised benefits, may result in disqualification, ineligibility, or a denial or loss of benefits. It must, therefore, be disclosed in the SPD."

The court went on to note that, while an SPD "need not anticipate every possible idiosyncratic contingency that might affect a particular participant's or beneficiary's status," employer underreporting was not an "idiosyncratic contingency" for the Fund, since the federal government had previously brought a RICO suit against Fund officials, alleging that they sought payoffs from employers in exchange for not pursuing the employers' delinquent contributions. The court thus held that "where it is the policy of a fund to require participants to produce records of covered employment in the event of employer underreporting, particularly where the fund has a demonstrated history of underreporting, the fund's failure to mention that policy in its SPD is a violation of [ERISA § 102(b)] and its regulations."

The Fund's issuance of a deficient SPD did not automatically entitle Wilkins to additional plan benefits. Rather, the Second Circuit remanded the case to the district court, and instructed that Wilkins could prevail on his claim only if he could demonstrate that he was "likely prejudiced" by the SPD's omission.

**Observations** – The Second Circuit's decision in *Wilkins* confirms that plans may place the burden of proof on participants to establish entitlement to pension benefits when the participant alleges that he or she worked unreported hours. However, administrators should carefully review plan policies concerning what evidence it will accept, and then verify that the plan's SPD and other written communication accurately reflect the policy. Such disclosure is especially important in plans and industries that have a history of problems collecting or maintaining accurate work hour reports.

While *Wilkins* involved a multiemployer plan, nothing in the court's reading of the SPD rules suggests that its holding is limited to such plans. There certainly may be circumstances where a single employer plan requires a participant to prove entitlement to additional plan benefits (e.g., the plan sponsor's payroll or service records may be incomplete, or may have been purged after a certain number of years). Consequently, single- and multiemployer plans may wish to include language such as the following in their SPDs:

"Your eligibility for benefits and the amount of your benefits will be determined based on plan records. If you believe that plan records are not accurate or complete, you will need to provide documentary evidence to support your claims. For example, pay stubs might provide support for claims of additional service and/or compensation in calculating eligibility, vesting or benefit credit."

## **8. California's Unrelated Business Tax Not Preempted**

The IRS Code has long imposed an unrelated business income tax on debt-financed and certain other investments of otherwise tax-exempt pension funds (Code secs. 511-14). (More attention has focused on these rules recently in hedge fund and similar transactions.) New York and California – two large high-tax states – generally mirror the IRS Code and thus also impose the same UBIT scheme on pension funds within their borders.

In a case of first impression, a New York appeals tax tribunal ruled in 2003 that NY's UBIT scheme could not be imposed on ERISA-covered plans on the grounds of ERISA preemption. In The Matter of McKinsey Master Retirement Plan Trust (Qualified Plans 2003-6). Although the federal UBIT provisions quite clearly were intended to apply to IRS-qualified retirement plans, the court could not discern any intent that Congress expected or intended states to impose similar measures. The NY court found that complying with state UBIT law imposed additional recordkeeping and accounting requirements on ERISA plans to a substantial extent and potentially also affected investment strategies. Accordingly, the court found the impact of the NY UBIT on plans to be more than "remote, tenuous and peripheral" and thus preempted by ERISA.

Significantly, the Second Circuit (the federal appeals court sitting in NY) recently rejected the

AT&T pension trust's claim that California's UBIT scheme was preempted by ERISA. Hatten v. Schwarzenegger, 2006 WL 1409363 (May 23, 2006). In essence, the court examined the same arguments as the NY court, but did not find them persuasive in light of post-Travelers court decisions in the preemption area. Notably, the Second Circuit did not even cite the McKinsey state court decision on New York's UBIT provisions.

## **9. Puerto Rico Catches Up**

The legislature of Puerto Rico has just enacted Act No. 92, effective May 16, 2006, to permit catch-up contributions for participants with a cash or deferred contribution agreement who turn age 50 by the end of the plan year. The P.R. catch-up limit for the 2006 Plan Year is \$500, and \$1,000 thereafter. As with U.S. catch-up contributions, P.R. catch-up contributions are not subject to nondiscrimination testing, and are able to receive matching contributions. However, the P.R. amounts are considerably lower than the U.S. 401(k) catch-up limits – \$5,000 for 2006 – and, unlike U.S. catch-up contributions, the P.R. limits are not indexed for inflation, and the age-50 determination appears to be made based on a plan year, rather than the tax year.

The immediate impact of this change for employers with U.S. and/or Puerto Rico 401(k) plans covering P.R. workers or "dual qualified" plans is unclear. Since 2002, employers that have adopted catch-up contributions in their 401(k) plans have relied on IRS Notice 2002-4 to exclude Puerto Rico participants from receiving catch-up contributions, notwithstanding the general "universal availability" requirement. Specifically, Notice 2002-4 states:

until the issuance of further guidance, an applicable employer plan (within the meaning of Code §414(v)(6)(A)) that permits catch-up contributions will not fail to satisfy the requirements of Code §414(v)(4) or Proposed Regulations §1.414(v)-1(e) solely because another applicable employer plan maintained by the employer that is qualified under Puerto Rico law does not provide for catch-up contributions.

Now that the Puerto Rico law has changed, we would expect future IRS guidance to address issues such as whether P.R. catch-up must be adopted to satisfy "universal availability," when amendments must be made, etc.

We note also that the Treasury is working on a project to permit existing "dual qualified" plans to opt out of the U.S. qualified plan rules during a limited window. This would be helpful for any plan that (1) made an irrevocable ERISA section 1022(i) election to treat a Puerto Rico trust as a U.S. trust, and (2) would like to eliminate the dual qualified status of the plan without adverse tax consequences (e.g., risk of reversion tax, taxation of plan participants, violation of the exclusive benefit rule, etc.) that typically could arise with a transfer of assets from a U.S. plan to a foreign plan. Presumably, the guidance will provide general relief from these issues (similar to several private letter rulings that permit a transfer from a dual qualified plan to a Puerto Rico qualified plan), and hopefully eliminate the U.S. taxation of the accrued earnings for Puerto Rico participants.

Plan sponsors and administrators with plans covering P.R. workers should stay tuned for further IRS developments.