

QUALIFIED PLANS 2006-6

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1. Update on Pension Reform Conference

As we go to press, Congress has left Washington for its July 4th recess without reaching agreement on comprehensive pension reform legislation. Despite earlier reports that conferees had reached a tentative agreement on some of the key issues holding up progress on the bill -- most notably on how to determine whether a plan is "at-risk" and therefore subject to stricter funding requirements -- it appears that there have been setbacks in the last week or so. After missing self-imposed deadlines based upon the Easter, Memorial Day, and July 4th recess periods, conferees now say that they hope to finish the bill prior to the longer, 5-week August recess. If the legislation is not completed by then, action may carry over to the Fall -- some key staff have even speculated that negotiations could run into a "lame-duck" session after the November Congressional elections.

2. Treasury, IRS and SEC Officials Comment on Current Executive Compensation Issues

Last week, the American Law Institute-American Bar Association (ALI-ABA) held its two-day annual conference, Executive Compensation: Strategy, Design, and Implementation. Representatives from the Treasury, Internal Revenue Service (IRS) and the Securities and

Exchange Commission (SEC) presented the latest government views on upcoming guidance under Code section 409A, stock option grant timing, and the new SEC disclosure rules for executive compensation. We share some of their observations here.

A. Section 409A Guidance Topics

Timing of Final Regulations/Extension of Transition Relief. Regulations under 409A are still expected in the "late summer or early fall." Treasury and IRS representatives suggested that perhaps not

all of the currently proposed 409A regulations ("Proposed Regulations," see Qualified Plans 2005-10) would be finalized at that time, but a portion may be re-proposed. Treasury and IRS representatives also indicated that an extension of all or some of the transition relief that was granted under the Proposed Regulations may be warranted, but it is not clear how long such an extension might last.

"Bifurcation" of Severance Arrangements.

The IRS received numerous comments requesting that severance amounts exempt from 409A not be aggregated with amounts subject to 409A where the amounts are payable under the same arrangement. This issue may arise in the context of involuntary severance pay arrangements. A severance arrangement that provides for payments upon an involuntary termination of employment may be exempt from 409A if the entire amount payable under the arrangement does not exceed two-times the employee's annual compensation or, if less, two-times the maximum amount of compensation that can be taken into account under a qualified plan under Code section 401(a)(17), indexed (e.g., two-times this amount for 2006 terminations is \$420,000). The IRS is considering whether to allow "bifurcation" of involuntary separation pay amounts that exceed the two-times pay limitation. Under that approach, the amount falling under the cap (e.g., \$420,000 in 2006) would be exempt from 409A, while the amount over the limitation would remain subject to 409A (e.g., six-month delay for "key employees"). This would allow more flexibility in the design of purely involuntary separation pay arrangements.

"Good Reason" Payment Triggers. Even where a severance arrangement does not fit within the safe-harbor exception for *involuntary* separation pay arrangements described above, it may still fit within the "short-term deferral" exception generally covering amounts payable within 75 days of vesting. If a plan provides for severance upon a voluntary termination (e.g., for "good reason"), the preamble implies that the short-term deferral exception will not apply through the IRS requested comments on this issue. Treasury and IRS has representatives said that the IRS has received two types of comments and that both are being considered: (1) comments requesting a safe-harbor definition of "good reason" that would allow an arrangement to use this exception, and (2) comments requesting a "facts and circumstances" test to determine whether a particular "good reason" definition works.

Stock Option Exercise Extensions. The Proposed Regulations set forth rules governing the

types of modifications, extensions, or renewals of stock options and SARs that could subject an otherwise exempt award to 409A. Treasury and IRS representatives indicated that consideration is being given to relief for certain stock option exercise extensions that are merely "interim" measures and which arise in certain specific circumstances. For example, relief may be provided where an employee with stock options is terminated in connection with an asset sale or even in some instances unrelated to any transaction. The employee's termination may trigger a shortening of the option exercise period (e.g., 90 days following termination) even though the buyer intends to hire the employee and would like to continue to motivate the employee with the same stock option following the employee's hire. To accomplish that, the buyer may need to extend the employee's option exercise period. Under the Proposed Regulations, it is unclear whether this type of interim extension of the stock option exercise period would be considered a modification of the stock option that would subject the grant to 409A. We expect clarification of this issue, but the scope is unclear at this point.

The Proposed Regulations exempt options and SARs covering certain types and classes of stock – called "service recipient stock." "Service recipient stock" under the Proposed Regulations generally is limited to one class of stock per controlled group. IRS is considering comments that request a broader definition of service recipient stock, which might include, for example, stock of more than just the public company in a controlled group (e.g., stock of a wholly-owned company in a particular line of business). Moreover, additional guidance is anticipated that will clarify how the service recipient stock rules will work in other types of business arrangements, like joint ventures.

Other Future Guidance. Future guidance can be expected as to the following issues:

- measurement of amounts deferred under arrangements subject to 409A,
- tax reporting of deferrals and income inclusions (practitioners can expect guidance with respect to 2006 reporting obligations similar to that provided for the 2005 tax year; see Qualified Plans 2005-12), and
- offshore funding and financial health triggers.

Interestingly, the Treasury and IRS representatives also indicated that consideration was being given to guidance on the issue of correcting 409A violations. It is not clear as to when any of the additional guidance listed above might be expected.

B. Timing of Stock Option Grants

Another "hot topic" that was discussed periodically throughout the conference was the timing of stock option grants, known in more pejorative terms as "stock option backdating". Discussion of the key tax consequences of this recent phenomenon is contained in Qualified Plans 2006-5, but options that are not granted at fair market value also may create the need for financial restatements and other disclosures. Speakers suggested that companies review their current stock option grant practices, prepare for increased audit attention (e.g., both internally under Sarbanes-Oxley and externally), expect increased scrutiny from its directors and officers' insurance carrier, and in some cases, prepare for increased attention from the media and shareholders.

C. New SEC Disclosure Rules

SEC representatives indicated that it was still the SEC's intention and desire to finalize the recently proposed SEC disclosure rules for executive compensation in time for the 2007 proxy season (see Qualified Plans 2006-2). Some companies are already filing proxy materials in accordance with the standards set forth in the proposed rules, although that is not necessary. Not surprisingly, indications are that the final rules may include supplemental requirements regarding disclosure of a company's option grant practices.

3. Two Significant Company Stock Rulings

This week, the courts handed down two important decisions in ERISA "stock drop" cases. These new decisions – both involving the ESOPs of financially troubled airlines – may help to settle the law on when a fiduciary of an eligible individual account plan designed to invest in qualified employer securities has a duty to rid the plan of those employer securities, as well as on the potential liability of directed trustees. We summarize them below.

A. DiFelice v. US Airways, Inc.

DiFelice v. U.S. Airways, Inc., No. 1:04cv889 (E.D. Va., June 26, 2006), involved a participant-directed 401(k) plan sponsored by US Airways. The plan included as one of several investment options an investment fund consisting primarily of the publicly-traded stock of the airline's parent holding company. After the airline filed bankruptcy in 2002, a class of participants sued, claiming (among other things) that the airline, as the plan's named fiduciary, had breached its fiduciary duty under ERISA by allowing that company stock to remain as a plan investment option while the airline headed toward bankruptcy. More specifically, the plaintiffs claimed that ERISA's "prudent man" standard of care required the airline to eliminate the company stock fund in view of the increasing risk of a bankruptcy filing by the airline.

In 2005, the district court denied the airline's motion for summary judgment on that claim, reasoning that the claim turned on disputed issues of fact. The court held a six-day bench trial on the claim earlier this year, and heard testimony from 11 fact witnesses and 7 expert witnesses. Based on that testimony and on other documentary evidence, the court concluded that plaintiffs' evidence failed to establish imprudent conduct on the part of the airline.

In reaching that conclusion, the court used modern portfolio theory and efficient market theory as guideposts for applying ERISA's prudent man standard of care. The district court noted as an initial matter that ERISA does not judge the prudence of maintaining a company stock investment option under a plan like US Airways' plan based on the individual risk and return characteristics of the company stock, standing alone. Rather, and consistent with modern portfolio theory, the court held that "ERISA requires that the prudence of selecting a particular investment be viewed in light of its contribution to the risk and return of the entire portfolio, and not in light of its individual risk." On the second point, the court observed that, "[b]ecause the risks facing US Airways were publicly disclosed,[] the unit price of the Company Stock Fund reflected the risk that the Group's bankruptcy filing would diminish or eliminate the value of the shares at all times during the class period." Further, "because investors who assume greater risk are compensated for that risk with the possibility of greater returns, the price of [the Company stock] offered participants a potential return far in excess of other Plan investment options." Finally, the district court observed the

many steps taken by US Airways to provide information to participants about the Plan's investment options, including the company stock fund. Taking these points together, the district court framed the prudence question as "[w]hether, in its role as Plan fiduciary, US Airways provided plan participants with the investment options and the information necessary to allow the participants to construct a diversified portfolio. If these requirements are met, and the record clearly so reflects, US Airways has satisfied its fiduciary duty to act prudently under ERISA when selecting and monitoring the Plan's investment options."

Of the more than 100 ERISA "stock-drop" cases filed to date, DiFelice is only the second to be resolved following a full-blown trial on the merits. The district court's ruling on the merits in DiFelice is likely to shape how other courts apply ERISA's prudent-man standard of care in stock-drop cases, like DiFelice, that involve publicly traded employer securities, a "404(c)" plan with diverse and well-explained investment options, and no allegations of securities fraud or market manipulation. In those circumstances, the standard applied by the district court in DiFelice posits that "a fiduciary may continue to offer employee stock as an investment option in a 401(k) Plan as long as the fiduciary also provides Plan participants, as here, with (1) a range of investment options; (2) true and accurate information regarding the risk/return characteristics of those investment options; and (3) the unfettered ability to trade in and out of those investment options."

B. Summers v. State Street Bank & Trust Co.

In Summers v. State Street Bank & Trust Co., Nos. 05-4005, 05-4317 (7th Cir. June 28, 2006), a Seventh Circuit panel affirmed a district court decision granting summary judgment for the directed trustee of an employee stock ownership plan sponsored by United Air Lines. The Seventh Circuit's opinion, written by Judge Richard Posner, powerfully rejects the premise of most ERISA stock-drop claims, *i.e.*, that a fiduciary can predict a company's future more accurately than the composite judgment of the marketplace as reflected in the market price of the company's stock.

United Air Lines filed bankruptcy in 2002. At the time, more than half of the airline's stock was held in the ESOP. Participants sued the ESOP's named fiduciary and the ESOP's directed trustee (State Street) claiming that each should have replaced the ESOP's stock with some other security

before the airline slipped into bankruptcy. Plaintiffs' principal theory was that both defendants knew or should have known that a bankruptcy filing was highly likely when, in the wake of the September 11, 2001 terrorist attacks, United's CEO wrote a letter warning employees that the airline was "in a struggle just to survive." Like DiFelice, Summers involved no allegation of securities fraud or market manipulation.

Plaintiffs settled their claims against the ESOP's named fiduciary. The district court granted summary judgment for State Street (the directed trustee) based on: (i) the theory an ESOP's directed trustee has a duty to dispose of company stock (absent a direction to do so) only "upon reliable information that shows an imminent collapse because otherwise a fiduciary could be cajoled into prematurely selling off an employer's securities;" and (ii) a conclusion that the evidentiary record, including the CEO's October 2001 warning letter to employees, gave State Street no such indication of an "imminent collapse." Summers v. UAL Corp., 2005 WL 2648670 (N.D. Ill. Oct. 12, 2005).

Plaintiffs appealed the district court's grant of summary judgment for State Street, perhaps hopeful that the appellate court would see the CEO's warning letter to employees as the kind of evidence sufficient to create a triable issue of fact under the "imminent collapse" standard invoked by the district court. The appellate court, however, took a different tack.

As an initial matter, the court of appeals agreed that a directed trustee has *some* level of fiduciary responsibility with respect to the choice of trust assets, even in an ESOP. On this point, Judge Posner essentially endorsed the standard articulated in the Labor Department's 2004 Field Assistance Bulletin on the Fiduciary Responsibilities of Directed Trustees (Qualified Plans 2004-12) – *i.e.*, a trustee may disobey the named fiduciary's directions when it is plain that they are imprudent.

But when does an ESOP's continued holding of company stock plainly become imprudent? On this question, Judge Posner criticized a key premise of the "imminent collapse" theory for identifying when the duty to sell might be triggered. As Judge Posner saw things, the plaintiffs (and to some extent, the lower court) had assumed that qualitative indicators, such as the CEO's October 2001 warning letter to employees, should have alerted plan fiduciaries that the airline was destined for bankruptcy. "That is wrong," wrote Posner. "After the market 'read' the letter, it valued United stock at \$15.05 a share. Had the market thought that United

would be bankrupt by the end of 2002, it would not have priced the stock that high in October 2001, . . ." For this and other reasons, "[a] trustee is not imprudent to assume that a major stock market . . . provides the best estimate of the stocks traded on it that is available to him. . . . Thus, at every point in the long slide of United's stock price, that price was the best estimate available to State Street and [the named fiduciary] of the Company's value, [] and so neither fiduciary was required to act on the assumption that the market was overvaluing United."

Having concluded that the Summers plaintiffs built their prudence case on a faulty legal theory, the court of appeals upheld the summary judgment in State Street's favor. But Judge Posner's opinion did not stop there. In obiter dictum, Judge Posner suggested an alternative theory for establishing an ESOP fiduciary's duty to sell company stock. That theory, previewed in dictum in an earlier ESOP decision authored by Judge Posner (Steinman v. Hicks, 352 F.3d 1101 (7th Cir. 2003), Qualified Plans 2003-12), posits that ERISA's duty of prudence "could" require diversification "if the ESOP was the [employees'] principal retirement asset . . . and was entirely invested in the stock of their employer" and if an event, such as a rise in the company's debt-to-equity ratio, materially increased the company's risk of bankruptcy. According to Judge Posner, the "source of the duty to diversify would not be the trustee's disagreement with the market valuation (their failure to predict the company's impending collapse), but the excessive risk imposed on employee-shareholders by the rise in the debt-equity ratio of the employer's stock as a result, in the example given in Steinman, of a merger and in our case of a plummeting stock price."

Importantly, Judge Posner grounded his possible risk-based duty to diversify in the "prudence" requirement set forth in ERISA § 404(a)(1)(D). But he did not expressly try to reconcile his theory with ERISA § 404(b)(2), which provides that, in the case of an eligible individual account plan, both the diversification requirement in ERISA § 404(a)(1)(C) "and the prudence requirement . . . to the extent it requires diversification" are not violated by the plan's acquisition or holding of qualifying employer securities. Nor did Judge Posner attempt meaningfully to grapple with the publicly-available facts showing that the ESOP was only one of several plans through which United offered retirement income for the Summers plaintiffs.

As obiter dictum, Judge Posner's ruminations about a possible risk-based duty to sell company

stock are non-precedential. But they could shape the way that other courts (and other plaintiffs) analyze the duty-to-sell question in cases involving ESOPs or other non-diversified individual account plans.

4. Department of Energy Suspends Policy on Pension Reimbursements

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) (Qualified Plans 2006-5). Amid mounting pressure from Congress, labor unions, and the employee benefits community, Energy Secretary Samuel Bodman, in a June 19 statement, suspended this policy for one year.

The Secretary's decision to suspend the DOE policy to stop reimbursing expenses for defined benefit plan coverage appears to be due to pressures from Congress. Specifically, the Chairman and Ranking Member of the Senate Committee on Energy and Natural Resources, Senators Pete Domenici (R-NM) and Jeff Bingaman (D-NM), sent a letter to Secretary Bodman requesting that the policy be suspended so that Congress and the Administration could further study its impact on stakeholders. The Senators stated that they understood that the rising cost of benefits in relation to the DOE budget needs to be addressed, but urged restraint in implementing a policy that could undermine the work that private contractors provide to the government in the area of clean-up, new technologies, and national defense.

In addition, on May 24, the House of Representatives approved an amendment that would block the use of federal funds for implementation of the DOE policy. The amendment was included in the Energy and Water Development Appropriations Act (H.R. 5427). The appropriations bill awaits passage in the Senate.

House and Senate Democrats, led by Congressman George Miller (D-CA) and Senator Ted Kennedy (D-MA), welcomed the DOE Secretary's suspension of the policy, but argued that suspending the "ill-advised" policy is not enough. Kennedy and Miller, who had previously introduced stand-alone bills that would have forced the DOE to

withdraw its policy (H.R. 5362 and S. 2794) (Qualified Plans 2006-5), contended that the Administration should be committed to strengthening the nation's private pension system instead of contributing to the extinction of the defined benefit plan. It is unclear whether the DOE's pension policy will be withdrawn altogether.

5. PBGC Requires Electronic Premium Filing

Starting with filings for plan years beginning in 2006 made on or after July 1, 2006, PBGC premium filings for plans with 500 or more participants must be made electronically. 71 Fed. Reg. 31077 (June 1, 2006). Premiums for smaller plans must be filed electronically for plan years beginning after 2006. (Electronic filing of premium information had been an option under PBGC's "My PAA" program since 2004.) Although the new PBGC regulation requires electronic filing of premium information, it does not require electronic payment of premiums.

PBGC has moved to mandatory electronic filing to reduce the problems and delays that arise in processing thousands of paper filings each year. The agency will consider exemptions from the electronic filing requirement for "good cause in appropriate circumstances." PBGC is unable at this time, however, to provide guidance on when it will grant exemptions, other than to note that a "massive breakdown" in the Internet or the electronic premium filing system could be cause to grant an exemption. PBGC may provide more guidance in the future as it gains experience with exemption requests in this area.

6. PBGC Finalizes Formula for Liability on Cessation of Facility Operations

With the publication of its regulation in final form, PBGC now has a definite formula for assessing liability against plan sponsors (and their controlled group members) in connection with a cessation of operations described in section 4062(e) of ERISA. 71 Fed. Reg. 34819 (June 16, 2006). The regulation, proposed last February (Qualified Plans 2005-3), applies to events under section 4062(e) occurring on and after July 17, 2006.

A section 4062(e) event occurs when an employer ceases operations at a facility and, as a result, more than 20% of the employees who are participants under its defined plan are separated from employment. This, in turn, triggers potential

liability under section 4063 of ERISA (involving a payment in escrow or bond favoring PBGC for the potential liability). The statutory liability formula in section 4063 – designed for a substantial employer's withdrawal from a multiple employer plan – is difficult to use in connection with a section 4062(e) event under a single employer plan, and had long hampered PBGC's efforts to assess liability.

The new regulation provides a formula to use under section 4062(e). Under the regulation, the liability assessed is a percentage of the liability that would have arisen under section 4062 of ERISA if the plan had terminated on the date the facility ceased operations. The percentage is determined by dividing the number of employees who are participants in the plan and were separated from service as a result of the cessation of operations by the total number of employees who were participants in the plan before the cessation of operations.

In response to comments, PBGC agreed that guidance in determining what constitutes a "cessation of operations" under section 4062(e) is warranted, but declined to provide guidance at this time. Until additional guidance is provided, PBGC will resolve issues on a case-by-case basis.

7. DOL and Federal Financial Regulatory Agencies Restate Interagency "Referral" Agreement

The Department of Labor ("DOL") recently restated its 26-year old "Interagency Agreement" with the federal financial institution regulatory agencies, including the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the "Agencies"). www.occ.treas.gov/ftp/bulletin/2006-24a.htm. This agreement provides that the Agencies will provide DOL written notice of possible ERISA violations that are "of a significant nature" if discovered in the course of these Agencies supervision of the fiduciary activities of financial institutions.

The restated Interagency Agreement adds to a list of violations that are considered to be "of a significant nature" a new potential ERISA violation, specifically, possible violations of ERISA section 405, relating to liability for breach of "co-fiduciary duties," except where the transaction amounts are less than \$100,000. Possible breaches of co-

fiduciary duty are described as including, specifically, transactions directed by named fiduciaries or qualified investment managers.

The Interagency Agreement already includes the following other possible violations that could be "significant" –

- any possible violations of ERISA section 404, relating to a breach of fiduciary duty (unless the transactions amount is less than \$100,000),
- possible violations of sections 406 and 407(a), relating to prohibited transactions (except where the threat of loss to plan participants is de minimis),
- possible violations of section 411, which prohibits certain persons from holding certain positions, or the bonding requirements under section 412, and
- if the financial institution also serves as the plan administrator or plan sponsor, possible violations of any of ERISA's reporting and disclosure provisions.

The restatement of the Interagency Agreement is a reminder to financial institutions sponsoring plans or providing plan services that reviews, audits and investigations by any of the Agencies may bring to light ERISA violations that may be referred to DOL for further review and action.

8. IRS FAQs on New Form 8905 and Other Determination Letter Issues

Earlier this year, the IRS issued Form 8905, a new form to be used by an employer maintaining an individually-designed qualified plan to certify its intent to adopt a pre-approved plan (i.e., an M&P or volume submitter plan), such as a prototype plan sponsor's basic EGTRRA plan document. Because the IRS is still reviewing EGTRRA documents, they are not available for adoption at this time. (It is anticipated that they will be available in 2008.) In this situation, instead of adopting the prototype sponsor's GUST plan document, the employer and pre-approved plan sponsor could complete Form 8905, certifying that the employer intended to adopt the EGTRRA plan document when it becomes available.

Form 8905 was issued in conjunction with the IRS' new determination letter procedures (Rev. Proc. 2005-66, Qualified Plans 2005-8). Under these procedures, an individually-designed single employer plan generally is subject to a 5-year filing cycle. In contrast, an employer plan based on a pre-approved plan document is subject to a 6-year filing cycle. If an employer wants to adopt a pre-approved plan document, but the plan's 5-year cycle would expire before the pre-approved plan document is available for adoption, the employer can complete Form 8905 instead of filing its individually-designed plan for a determination letter. This will extend the plan's remedial amendment period so that the employer can either adopt a pre-approved plan document, or another individually-designed plan, within the time-frame that applies to employers adopting pre-approved plans. Form 8905 must be completed by the time the employer would otherwise have to submit its plan to the IRS for a determination letter.

Numerous questions have arisen with regard to Form 8905. Many of these are answered in the FAQs recently published on the IRS' website. The FAQs clarify that –

- Form 8905 must be filed with the IRS only if the employer ultimately files a determination letter application. If no application is filed, the employer should simply keep the Form in its records.
- Form 8905 may be used if the employer plan's 5-year cycle ends before the deadline for filing a pre-approved plan with the IRS. For example, Form 8905 could be used by a Cycle A employer wishing to adopt a pre-approved defined benefit plan even though such pre-approved plans are not due to be submitted until the period February 1, 2007 – January 31, 2008.

In addition, the FAQs confirm or highlight the following points:

- **Controlled Group Election of Filing Cycle** – A parent-subsidiary controlled group that maintains more than one plan may elect to file all its plans during either (a) filing Cycle A or (b) the filing cycle based on the last digit of the parent's EIN. Alternatively, the employers within the controlled group may file their plans separately, based on each employer's EIN. This election

should be made by the end of the earliest cycle for which a determination letter application would be due under the regular timing rules. For example, if a parent company plan falls under Cycle E and a subsidiary plan falls under Cycle A, an election to file both plans under Cycle E should be made by the end of Cycle A and submitted with the determination letter applications during Cycle E. (The rules for making these elections are found in Rev. Proc. 2005-66, Sections 10.6 – 10.8.)

- **Interim Amendments for 401(k) Regulations** – Interim amendments to reflect the 401(k) regulations that became effective for 2006 must be adopted within the time-frame for adopting interim amendments, *i.e.*, amendments to address discretionary items are due by the end of 2006 and amendments to address non-discretionary items are due by the employer's income tax filing date (taking into account any extension only if the employer files for an extension).
- **Plan Restatements** – Employers must restate their plans for on-cycle determination letter filings.
- **Off-Cycle Filings** – The IRS will review off-cycle filings after it has completed its review of on-cycle filings. At a later date, the IRS will assess whether there is a need to prioritize among off-cycle filings, *i.e.*, whether certain types of off-cycle filings should be reviewed before others.
- **User Fee Increase** – User fees for opinion, advisory, and determination letter applications will increase for applications postmarked on or after July 1, 2006. (The new user fees were discussed in Qualified Plans 2005-12.)

9. **IRS Rules on Insurers Offering "Retail" Fund Shares to Retirement Plans**

Insurance companies maintain separate accounts for so-called "nonqualified" variable annuities as well as for tax-qualified retirement plan

customers. Typically, insurers establish separate accounts for each type of business. In the case of nonqualified variable annuities, the separate accounts must be registered as investment companies in accordance with SEC requirements and are subject to investment diversification requirements under Code section 817(h); separate accounts that only hold assets of tax-qualified retirement plans are exempt from these requirements.

The IRS diversification rules contain "look-through" rules allowing them to be applied based on the underlying assets of the investment company itself if, in general, only one or more insurance companies own the assets of the account. However, IRS has permitted beneficial interests owned by a long list of tax-favored retirement plans to be ignored for this purpose. Rev. Rul. 94-62. This is because accounts for such plans are themselves exempt from diversification requirements.

Two recent IRS private letter rulings provide a way for registered separate accounts to be offered to retirement plan customers without affecting "look-through" treatment as to the underlying funds under the diversification rules. PLRs 200607011, 200613028. The rulings establish very specific procedures for insurers to follow to establish that the "retail" customers are tax-favored retirement plans exempt from the IRS diversification rules.

The procedures IRS outlines are quite elaborate, but, in general, require –

- the plan to identify itself, the employer, administrator and/or custodian,
- the plan to represent that it is described in at least one of the tax-favored "plan" categories listed in Rev. Rul. 94-62, and that it is not aware of any operational or document qualification failure,
- the fund has no knowledge contrary to the plan's representations,
- in the event of qualification failures (other than those being addressed in an EPCRS filing), the fund be notified and redeem the plan's shares within 90 days,
- periodically (at least every 3 years), the fund solicits updated information on the

customer's qualified status and obtains at least 50% "re-affirmation" (75% for very small separate accounts), and

- the fund maintains records sufficient to demonstrate compliance with all of the foregoing to the IRS.

Whether the detailed procedures that IRS has worked out with the two taxpayers who received these rulings are workable – and will prompt similar applications by other companies – remains to be seen. The IRS has informally asked for feedback on the rulings. Ultimately, official guidance – such as a revenue ruling or revenue procedure – is quite possible, but we would hope it would be much less burdensome.

10. IRS Guidance on When Section 83(b) Elections May be Revoked

The IRS recently outlined the limited circumstances under which it will allow a taxpayer to revoke a Section 83(b) election not to defer income from restricted stock or other property. (Rev. Proc. 2006-31, July 3 IRS Bulletin).

Generally, the transfer of property (e.g., restricted stock) for the performance of services is taxable as ordinary income at the time such property is no longer subject to a substantial risk of forfeiture (i.e., vested) or becomes transferable. The amount of ordinary income recognized is equal to the fair market value of the property at the time the property becomes vested or transferable, less any amount paid for the property. Alternatively, a taxpayer may elect to recognize income in an amount equal to the excess (if any) of the fair market value of the property at the time of transfer over the amount paid for the property by making a Section 83(b) election and filing it with the IRS within 30 days of the transfer of property.

The principal risk in making 83(b) elections is that the taxpayer recognizes income on unvested property which may never be realized. The potential "upside" is that this election will convert any subsequent appreciation in the value of the property from ordinary income to capital gain, which is subject to a lower tax rate so long as the property is held for more than one year.

The ability to revoke such elections was a particularly hot topic when the "tech bubble" burst, but the issue has been an ongoing one. Section 83(b)(2) and the corresponding regulations provide that, with IRS consent, a taxpayer may revoke a

Section 83(b) election made as a result of a "mistake of fact" as to the underlying transaction. The request must be filed within 60 days of the date on which the mistake of fact first became known to the taxpayer. The regulations further provide that a mistake as to the value (or decline in value) of the property or a failure to perform an act contemplated at the time of transfer of such property does not constitute a mistake of fact.

Revenue Procedure 2006-31 confirms the limited scope of the mistake of fact exception and defines mistake of fact as "an unconscious ignorance of a fact that is material to the transaction." This guidance further clarifies that neither a taxpayer's failure to understand the substantial risk of forfeiture associated with the property nor a taxpayer's failure to understand the tax consequences of making a Section 83(b) election will constitute a mistake of fact. A qualifying example, provided in the new guidance, involves the transfer of, and Section 83(b) election with respect to, the wrong class of common stock pursuant to an employment contract.

To obtain IRS consent to revoke a Section 83(b) election, a request must be made under the procedures for requesting a letter ruling (with a \$10,000 fee). This request must contain the following: (1) a complete description of the facts, (2) the date the Section 83(b) election was made, (3) a copy of the Section 83(b) election, (4) a description of the mistake of fact as to the underlying transaction, and (5) the date on which the mistake of fact first became known to the taxpayer.

Revenue Procedure 2006-31 also confirms the principle that an election made under the Internal Revenue Code or regulations may be revoked on or before the due date for making such election. Thus, a request for consent to revoke a Section 83(b) election will generally be granted, regardless of the reason for which it is filed, if the request is filed within the 30-day period following the transfer of property and this fact is included in the request for revocation.