

QUALIFIED PLANS 2008-5

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1. **Congress Clears Pension and Tax Relief Legislation For Military**

Last week, the House and Senate passed legislation (H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008," also called "HEROES" or "HEART") that, among other things, would provide tax and pension relief to members of the military. The bill generally contains provisions that are identical to those in legislation passed by the House (see [Qualified Plans 2007-11](#)) and Senate (see [Qualified Plans 2007-6](#)) last year. This bill enjoyed overwhelming, bipartisan support in Congress, and the President is expected to sign it shortly. Key benefits and compensation provisions are described below.

A. **Pension and Compensation-Related Provisions**

- **Permanent Ability to Withdraw From Tax-Favored Retirement Savings Vehicles** – Currently, distributions of elective deferrals from a 401(k) or 403(b) plan to a military reservist – called to active duty on or after September 11, 2001 and before December 31, 2007 for more than 179 days – will not be subject to the 10 percent early withdrawal penalty tax if such distributions are made during the period of active duty. These amounts can be re-contributed to an IRA on an

after-tax basis over the two-year period after the reservist's active duty ends without affecting the annual contribution limit. Although this provision expired at the end of 2007, the bill would permanently allow individuals who are called up to active duty and serve more than 179 days to make penalty-free withdrawals and re-contributions within the two-year period following active duty.

- **Distribution of Unused FSA Amounts** – The legislation amends Code section 125 to allow distributions of unused amounts in health flexible spending arrangements ("health FSAs") to reservists called to active duty, thus providing relief from the IRS' strict "use it or lose it" rule. Specifically, new Code subsection 125(h) allows (but does not require) cafeteria plans to make tax-free "qualified reservist distributions," effective after the date of enactment. Under this provision, a cafeteria plan may distribute amounts in health FSAs to reservists ordered or called to active duty, provided (1) the order or call to active duty is for a period greater than 179 days or for an indefinite period and (2) the distribution is made between the date of the order or call and the last date that reimbursements from the health FSA could otherwise be made for the plan

year that includes the date of the order or call to active duty. We note that plans would need to be amended to make such qualified reservist distributions, and there are additional issues – such as the effect (if any) on a plan's obligations to provide continuation coverage under USERRA and COBRA – that we expect will be addressed in later guidance.

- **Treatment of "Differential Pay" as Wages** – Some employers make "differential payments" to reservists called up to active military service in an amount equal to the difference between their civilian compensation and military compensation. The tax treatment of these payments has been unsettled for many years. The IRS currently requires these differential payments to be reported on a Form 1099 – which increases the burden for both employers and employees in reporting compensation – while nevertheless allowing the payments to be the basis for pension contributions and accruals. The bill would treat differential payments as wages with reporting on the employee's W-2 generally beginning after 2008. The bill clarifies that (1) the differential payments are treated as compensation, (2) employees can make contributions to a retirement plan or IRA based on this compensation, and (3) individuals in military service at least 30 days are nevertheless treated as inactive so the prohibitions on in-service withdrawals of elective deferrals and certain other rules (e.g., top-heavy minimums) do not apply.
- **Rollover of Military Death Benefits to a Roth IRA** – The bill permits beneficiaries who receive military death benefits to contribute (as a rollover contribution) an amount that does not exceed such death benefits to either a Roth IRA or Coverdell education savings account and not be taxed on the contribution in the event a nonqualified distribution occurs. To be eligible for this special tax treatment, the contribution must be made to the Roth IRA or Coverdell account within one year of when the beneficiary

receives the military death benefit. The provision generally applies to deaths from injuries occurring on and after the date of enactment, but a transition rule also allows rollovers of certain prior death benefits within one year of enactment.

- **Certain Benefits For Death or Disability During Military Service** – Currently, when a participant in a tax-favored retirement plan returns to an employer following a period of military service, the plan must provide the participant with certain service credits (e.g., vesting credit for the period of military service, but not benefit accruals or other benefits). The legislation would require plans intended to qualify under Code section 401(a) (e.g., defined benefit and 401(k) plans), 403(b), and 457(b) (when maintained by a state or local government), to treat participants who die during a period of qualified military service as being reemployed and then dying. The effect of this provision – which would be a new tax-qualification requirement under Code section 401(a)(37), retroactive to January 1, 2007 – would be to require plans that provide accelerated vesting, pre-retirement death benefits, ancillary life insurance or other survivor benefits to participants who die in service under the plan to provide the same benefits to survivors of persons who die while on military duty. While the financial impact of this change should be limited – most often, multiemployer plans and governmental plans provide these types of benefits – all qualified plans ultimately may need to be amended to reflect the provision. In addition, plans would have the option to grant benefit accruals for the period of absence as if the deceased or disabled person had terminated service on such date, as long as the plan did so for all similarly situated participants on reasonably equivalent terms.
- **Plan Amendments** – Plans must be in operational compliance with this provision retroactive to January 1, 2007. However, plan sponsors generally have until the end of the first plan year that begins on or after

January 1, 2010 to amend their plans to comply with these requirements. Governmental plans generally do not have to be amended until the end of the first plan year that begins on or after January 1, 2012.

B. Revenue-Raising Provisions

HEROES contains several revenue-raising provisions, including one that revamps the rules for taxing individuals who expatriate or terminate long-term U.S. residency after the date of enactment. This provision is virtually identical to legislation passed by the House last fall and is similar to legislation passed by the Senate last year.

1. Expatriation Tax

- **Deemed Sale Upon Expatriation** – In general, the new rules would impose a "deemed sale" of all of the individual's assets based on the assets' fair market value on the day immediately prior to expatriation. The expatriating individual would then have to recognize any gain realized on the deemed sale to the extent it exceeds \$600,000 (indexed for inflation).
- **Application to Benefit Plans** – Most noteworthy to retirement plan sponsors and administrators, the legislation would also affect the tax treatment of amounts held by such individuals in a:
 - qualified plan,
 - 403(b) plan,
 - SEP and Simple IRAs,
 - deferred compensation plans maintained by the United States,
 - plans maintained by state or local governments (but excluding amounts deferred under Code section 457(b)),
 - any interest in a foreign pension plan,
 - any nonqualified deferred compensation, and
 - any right to property which has not been previously taxed under

Code section 83 (e.g., non-vested restricted stock awards).

In general, in the case of certain "eligible deferred compensation items," the employer would be required to deduct and withhold from payments from the plan to the individual a tax equal to 30 percent of the payment – in lieu of any other withholding requirements. To be an "eligible deferred compensation item" under the provision, (1) the employer/payor must either be a U.S. person or a non-U.S. person who elects to be treated as a U.S. person for purposes of these tax withholding requirements, and (2) the expatriate must notify the employer/payor of his status as a covered expatriate and must irrevocably waive any claim for a reduction in withholding under any treaty with the U.S. If the item is not an eligible item, then an amount equal to the present value of the expatriate's account is treated as having been distributed on the day before his expatriation date. If an amount that would be taxed under Code section 83 is not an eligible item, then this award is treated as vested and includable in income on the day before his expatriation date.

- **Application to IRAs, etc.** – If the individual maintains an IRA (not including SEPs or SIMPLE IRAs), a health savings account ("HSA"), a 529 qualified tuition program, a Coverdell education savings account, or an Archer MSA, then the individual will be treated as receiving a distribution of the entire account balance on the day prior the expatriation date. These deemed distributions are not subject to any early distribution tax, and the individual will receive basis in their account for the purpose of determining the taxable amount of future distributions from the account.

2. **FICA Treatment of Foreign Subsidiaries of U.S. Government Contractors**

The legislation also contains a revenue raiser intended to close a perceived tax loophole that enables U.S. companies under contract with the U.S. government to set up foreign subsidiaries in tax havens and treat American workers as employees of the foreign subsidiary. This would be accomplished by amending the FICA tax rules in the Code and under the Social Security Act to treat foreign subsidiaries of U.S. companies performing services under contract with the U.S. government as U.S. employers for purposes of Social Security and Medicare payroll taxes. The amended tax provisions would apply to a U.S.-controlled group of entities, with a U.S. parent company owning at least 50% of a foreign subsidiary (rather than 80%, as provided under the Code's definition of a "controlled group of corporations"), but would not apply to arrangements subject to a Code section 3121(l) totalization agreement. The foreign subsidiary would be responsible for reporting, withholding and paying Social Security and Medicare taxes from wages paid by the foreign subsidiary to its American workers. The U.S. parent company would be jointly and severally liable for the payroll taxes if the foreign subsidiary failed to comply. This provision would apply to services performed in calendar months that begin more than 30 days after enactment.

2. **Restrictions on Offshore Deferred Compensation Resurface**

The House recently passed legislation (H.R. 6049, "The Energy and Tax Extenders Act of 2008") that would extend various expiring tax provisions and provides incentives for renewable energy. The bill also includes a provision permitting individuals who have attained age 70 ½ to make tax-free distributions from an IRA to a charitable organization. The ability to make tax-free charitable distributions from an IRA was set to expire after 2007, but the provision would permit these distributions during 2008.

The bill includes a revenue-raising provision that would greatly restrict the use of certain offshore deferred compensation arrangements. This offshore deferred compensation provision is very similar to the provision contained in versions of tax extenders and "AMT patch" legislation passed by the House last year (See Qualified Plans 2007-10 and 2007-11). Although the House provision, summarized

below, is targeted principally at hedge fund managers, it could apply to any U.S. multinational that pays U.S. taxpayers through entities in certain foreign countries.

- **Income Taxation Upon Vesting** – The provision would add a new Code section 457A to tax compensation deferred under a nonqualified plan of certain foreign entities at the time of vesting (i.e., the deferred amounts would be includable in an employee's income when such amounts are no longer subject to a "substantial risk of forfeiture"). The restrictive tax treatment would apply to deferrals under nonqualified plans maintained by (1) any foreign corporation unless substantially all of its income is effectively connected with a U.S. trade or business, or subject to a "comprehensive foreign income tax," and (2) any partnership, unless substantially all of its income is allocated to persons other than foreign persons with respect to whom the income is not subject to a comprehensive foreign income tax, or to organizations which are tax-exempt.
- **Definition of Comprehensive Foreign Income Tax** – The term "comprehensive foreign income tax" is defined generally as an income tax of a foreign country if an applicable person is eligible for the benefits of a comprehensive income tax treaty, or Treasury otherwise determines that the foreign country has a comprehensive income tax. In a potentially helpful change from last year's bill, the foreign country's tax would not have to include rules for the deductibility of deferred compensation similar to the Code rules for it to be considered a comprehensive foreign income tax.
- **Expanded Definition of Nonqualified Deferred Compensation** – The term "nonqualified deferred compensation plan" is generally defined to have the same meaning as under Code section 409A, with several major expansions that could apply these new restrictions to forms of compensation that are generally excluded from the application of Code section 409A.

– **Certain Equity Compensation.**

Under the provision, the definition of "nonqualified deferred compensation plan" specifically includes amounts that are "based on the appreciation in value of a specified number of equity units". The Joint Committee on Taxation's ("JCT") description of the bill provides that this definition is intended to apply to stock appreciation rights, but not to fair market value stock options and restricted stock subject to Code section 83. Although the JCT description does not specifically address the treatment of restricted stock units ("RSUs"), it appears that RSUs could potentially be covered by the expanded definition in all cases – regardless of whether the more restrictive short-term deferral provision (described below) applies – because the amount ultimately distributed under an RSU typically is based, at least in part, "on the appreciation" of the underlying stock.

– **Restrictive Short-Term Deferral Exception.**

One of the most useful exceptions from the application of Code section 409A is for amounts that are considered "short-term deferrals" distributed within the first 2 ½ months of the year after the year in which the amounts are no longer subject to a substantial risk of forfeiture. The JCT description provides that compensation is subject to a substantial risk of forfeiture only if the right to the compensation is conditioned on the future performance of substantial services. Thus, the provision would not recognize a vesting condition that is "related to the purpose of the compensation" (e.g., performance-based conditions based on the satisfaction of objective performance criteria), as

permitted under the Code section 409A and 83 regulations. Although the short-term deferral exception would be narrowed for purposes of the application of the offshore restrictions, the bill would extend the 2-1/2 short-term deferral payment period to 12 months after the year of vesting.

- **"Not Determinable" Compensation** – If the amount of deferred compensation is "not determinable" at the time the compensation is otherwise includible in income, it is includible in income in the year it becomes determinable, and the tax imposed that year is increased by interest and a 20 percent penalty. This could cause compensation that is contingent upon the satisfaction of predetermined performance goals to be subject to these penalties.
- **Effective Date** – The amendment would generally be effective for amounts deferred that are attributable to services performed after December 31, 2008. However, amounts attributable to services before January 1, 2009 generally would be includible in income no later than 2017.

Recent statements by Senate Finance Committee Chairman Max Baucus (D-MT) indicate that the offshore deferred compensation restriction will be included in the Senate version of the tax extenders and energy bill that the Senate Finance Committee will consider later this summer. Informal discussions with Finance committee staff suggest that the next Senate version of this restriction might be more tailored to its intended targets, i.e., hedge fund managers. Nevertheless, it is likely that some version of the offshore provision will be included in the final tax extenders legislation, if such legislation includes revenue-raising provisions.

3. Potential Impact of White House Regulatory Deadlines on Benefits Regulations

Earlier this month, White House Chief of Staff Josh Bolten issued a memorandum to Agency and Executive Department heads that is likely to have an impact on the priorities and timing of tax and pension regulations between now and the end of the year. The thrust of the memo is for agencies to avoid establishing new initiatives "under the wire" of the outgoing Bush Administration. Specifically, the May 9 memo stated "[e]xcept in extraordinary circumstances, regulations to be finalized in this Administration should be proposed no later than June 1, 2008, and final regulations should be issued no later than November 1, 2008."

What this will mean for the regulatory activities of the Department of Labor ("DOL") and IRS/Treasury is anybody's guess at this point, but there has already been some speculation. On the IRS side, there are a dozen or so proposed rules outstanding on various topics – including several sets of Pension Protection Act ("PPA") funding rules, as well as PPA diversification and auto enrollment rules. Indications are that the PPA funding rules will get top priority, although we expect other PPA projects may also be moved up. We may have a better idea next month when IRS/Treasury issue their 2008-09 "guidance priorities," which they are now in the process of formulating and will announce in July. It is harder to tell what proposed regulations might get rushed out to meet the June 1 deadline – or how broadly the Administration will interpret the "extraordinary circumstances" exception.

On the DOL front, the big items in the works all revolve around expanded disclosure of 401(k) plan fees and service arrangements. They include finalizing the proposed service provider rules (Qualified Plans 2007-12), and upcoming expansion of the disclosure rules for "404c plans," which we understand are close to being released. Whether DOL can wrap up these controversial initiatives in time – and what compliance deadline they will impose – remains to be seen.

4. IRS Relief for Stimulus Payments Made to IRAs

The IRS recently announced a "fix" for IRA problems caused by the automatic deposit of economic stimulus payments, which are not subject to federal income tax. The problem is that the economic stimulus payments are sent to the same

place as the taxpayer's last refund, which can include direct deposit to an IRA. This can result in an excess IRA contribution for 2008. IRS Announcement 2008-44 (Apr. 30, 2008) states that the amount of any stimulus payment deposited in an IRA or certain other accounts can be withdrawn tax-free and penalty-free by the due date or extended due date for filing the taxpayer's 2008 return. This means April 15, 2009, for most taxpayers, or as late as Oct. 15, 2009, for those who obtain tax-filing extensions. The amount withdrawable is the amount deposited, unadjusted for earnings or losses; it does not have to be an excess contribution to be eligible for relief.

The guidance also indicates that an IRA custodian may report the deposit and distribution "in the usual manner" if it is unable to distinguish the stimulus payment from other payments.

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