ROBINSON & COLE LLP

Employee Benefits & Compensation

IRS Issues Proposed Section 403(b) Regulations

The IRS has issued proposed regulations updating the rules governing Section 403(b) plans. Sponsors of 403(b) plans will welcome this guidance, since it updates the rules to reflect changes in the law and more closely aligns the rules applicable to 403(b) plans with the rules governing 401(k) plans and 457(b) plans.

Plan Document Requirement. The most significant new provision of the proposed regulations is that plan sponsors will be required to maintain a written plan document containing all plan terms. Since many 403(b) plan sponsors have not historically maintained a plan document apart from the annuity contract, some cost and effort will likely be required of some plan sponsors to comply with this requirement. This requirement also presents questions as to whether such a document will render a 403(b) plan subject to ERISA. The DOL will be addressing that issue in upcoming guidance.

Non-Discrimination Rules.

- The new regulations formally adopt the same rule that is currently in place for 401(k) plans - elective deferrals to a 403(b) plan cannot exceed the cap on elective deferrals provided under the Internal Revenue Code ($13,000 for 2004).

- The qualified plan non-discrimination requirements for employer contributions are adopted.

- The universal availability requirement is retained, but liberalized. All employees must be permitted to elect deferrals to be contributed on their behalf if any employee is allowed to make such election. The proposed regulations retain the exceptions to the universal availability rule - employers can continue to exclude employees who are eligible to participate in a 401(k) or 457(b) plan which provides contributions for the employee; non-resident aliens; certain students; and employees who work less than 20 hours per week. The universal availability requirement applies separately to each common-law entity. Churches, universities, hospitals, and nursing homes are not subject to the universal availability requirement.

Severance from Employment. The proposed regulations state that an employee will be considered to have had a severance from employment even if the employee continues to be employed by an entity that is part of the same controlled group, but that is not an eligible employer.

Elective Deferrals. The proposed regulations adopt rules that are substantially similar to the rules applicable to 401(k) plans relating to the frequency with which a deferral election can be made, changed, or revoked; automatic enrollment for employees who do not opt out; and the compensation which is subject to deferral. The rules relating to payment of excess deferrals are similar to those applicable to 401(k) plans.

Catch-Up Contributions. Employees who participate in a 403(b) plan are entitled to both the catch-up contribution for years after the employee attains age 50 and a special 403(b) catch-up limit applicable to an employee with at least 15 years of service. The proposed regulations state that if an employee is entitled to both the age 50 catch-up contribution and the special 403(b) catch-up contribution, any catch-up contribution is treated first as a special 403(b) catch-up contribution and then as an age 50 catch-up contribution, to the extent that the age 50 catch-up amount exceeds the special 403(b) catch-up amount.

Loans. The proposed regulations state that loans can be made to participants from a Section 403(b) plan.

Qualified Domestic Relations Orders. The proposed regulations clarify that the QDRO rules apply to 403(b) plans.

There are now only three significant differences between 403(b) plans and 401(k) plans:

- Although 401(k) plans can be offered by all employers, except governmental entities, 403(b) plans can only be offered by employers that are tax-exempt organizations, public schools, and that employ ministers.

- 401(k) plan assets must be held in a trust. Contributions to 403(b) plans can only be made through certain funding arrangements: annuity contracts, custodial accounts limited to mutual fund shares, or church retirement income accounts.

- The non-discrimination rule applicable to 403(b) elective deferrals is the universal availability rule, as opposed to the average deferral percentage test and the minimum coverage test applicable to elective deferrals under 401(k) plans.

These rules are effective for taxable years beginning after 2005 and can not be relied upon until finalized.

IRS Proposes Rules on Phased Retirement Programs

The IRS has issued proposed regulations providing guidance to employers on phased retirement programs. The proposed regulations adopt a pro rata approach to phased retirement. An employee maintains a dual status of partially retired and partially actively employed during phased retirement. Phased retirement benefits may not be offered to employees who have not attained age 59½, part time employees or key employees. The regulations define "bona fide phased retirement program" as a written employer adopted program pursuant to which employees may reduce the number of hours they customarily work after a specified retirement date and commence phased retirement benefits. Employee participation must be voluntary and the employee must reduce his or her hours by at least 20%. Employers would be required to annually test the accuracy of the phased retirement program by comparing the number of hours an employee actually works with the number of hours the employee was reasonably expected to work.

Under the proposed rules, if a bona fide phased retirement program is in place, an employee can receive payment of a pro rata share of his or her accrued benefit reflecting the employee's reduced hours. The maximum phased retirement benefit is the portion of the employee's accrued benefit equal to the product of the employee's total accrued benefit on the date phased retirement benefits commence and one minus the employee's work schedule fraction. The election of a phased retirement benefit would be subject to the spousal consent rules. All early retirement benefits, subsidies and optional forms of benefits must be available to an employee with respect to the phased retirement accrued benefit; however, lump sum distributions may not be offered.

During the phased retirement period, the employee must continue to participate in the qualified plan in the same manner that he or she would have participated had he or she maintained a full time work schedule and must be entitled to the same benefits upon full retirement as employees who had not elected phased retirement, except that the years of service credited during phased retirement would be multiplied by the ratio of the employee's actual hours of service during the year to the employee's full time work schedule. The employee's final retirement benefit is comprised of the phased retirement benefit and the balance of the employee's accrued benefit under the plan. Upon final retirement, an employee can either continue with the phased retirement benefit or can make a new election with respect to that benefit.

The proposed regulations apply only to defined benefit pension plans and money purchase pension plans. Since the proposed regulations are not yet effective, plan sponsors cannot yet rely upon the regulations in establishing a phased retirement program. Plan sponsors that are interested in implementing a phased retirement program should continue to monitor developments as it is likely that these regulations will be changed in some manner before

they are finalized.

Benefit Plans will be Unaffected by Tax Code's New Definition of "Dependent"

The recently enacted Working Families Tax Relief Act of 2004 changed the definition of "dependent" under Section 152 of the Tax Code, effective January 1, 2005. Although the change was intended to provide consistency between the various provisions of the Tax Code that use the term dependent, in fact, the change resulted in some confusion as it related to group health plans. In order to alleviate concerns of plan sponsors about how the change impacts health plans, the IRS has issued Notice 2004-79. According to the Notice, existing regulations will be revised to clarify that employees can continue to exclude from income the value of employer provided heath coverage for dependents.

IRS Seeking Information From Charities

The IRS has announced that it is issuing letters to 2,000 charities requesting details on their executive compensation practices. The IRS anticipates that the responses to these letters will result in audits of some respondents.

COBRA Notice Requirements are Satisfied by Sending Letter Certified Mail

In the case of Powell v. Paterno Imports, a District Court in Illinois has ruled that an employer satisfied its COBRA notice obligation by sending the COBRA notice via certified mail. The employee failed to retrieve the certified letter from the Post Office even after being informed several times by the Post Office that it was holding the letter. The court found that the employer satisfied its obligation even though the employee chose not to retrieve the letter.

American Jobs Creation Act Expands Disclosure Requirements

The American Jobs Creation Act added a new penalty for failure to report certain reportable transactions on a required return or statement. The penalty is substantial - $10,000 for a person and $50,000 for an entity. Many transactions that occur in health and welfare benefit plans, retirement plans and insurance funded pension plans could be subject to this penalty if the plan fails to file a transaction disclosure statement on Form 8886. Guidance is anticipated from the IRS with respect to the details of reporting these transactions.

Additional Guidance Provided on Nonqualified Deferred Compensation

As reported in a Special Edition of benefits enews, a new tax law relating to nonqualified compensation comes into effect on January 1, 2005. The new law requires employers to report all amounts deferred for the year on an employee's Form W-2, even if the amount is not included in the employee's income for that year. Deferred amounts should be reported in Box 12 of Form W-2 starting with the 2005 Form W-2. The IRS has added a new Code Y - Deferrals under a Section 409A nonqualified deferred compensation plan - for the 2005 Form W-2 so that employers can report deferrals.

Legislation containing technical corrections to the new law has also been proposed in

Congress:

• If compensation is deferred under a plan that does not comply with the new law, the tax consequences are: (i) a penalty equal to 20% of the participant's compensation that becomes includable in income, which is in addition to the income tax due with respect to such amounts, and (ii) an interest charge equal to the underpayment rate plus 1%. The technical corrections clarify that this tax and interest would not be treated as payments of regular tax for alternative minimum tax purposes.

• The new laws prohibit the use of foreign trusts and generally prohibit the holding of nonqualified deferred compensation plan assets outside of the United States. If nonqualified deferred compensation plan assets are set aside in a foreign trust or other sites outside the United States, the deferred compensation will immediately be subject to income tax. The technical corrections clarify that amounts set aside in a foreign trust before 2005 are subject to the new funding rules.

• Triggers which result in the restriction of assets in the event that an employer's financial health deteriorates are prohibited by the new legislation. The technical corrections clarify that plans providing for such a restriction of assets are subject to the new funding rules

This is an archive of past issues. As a result, it may contain information that is not current.