As most clients are aware, transitional relief allowing taxpayers to operate in good faith compliance with the final regulations under Internal Revenue Code (“Code”) section 409A using plan documents that have not yet been revised to reflect the documentary compliance requirements of the final regulations expires at the end of 2008 and is not expected to be extended. Accordingly, deferred compensation plans that are subject to section 409A must be in documentary compliance with the requirements of section 409A after 2008. If a plan document does not meet the documentary compliance requirements of section 409A after that time, there will be a violation of section 409A for all plan participants as of January 1, 2009. In that case, participants’ vested benefits will be taxable under section 409A, and subject to the 20 percent and interest charge penalty taxes. Although the Treasury has not yet released regulations detailing how the taxable amount is required to be calculated, we can nonetheless expect that employers with non-compliant plans will be required to report some amount on the participants’ Form W-2 for 2009, using Code Z, as violating section 409A.

Clients should give serious consideration to whether they are currently on target to meet the documentary compliance deadline. We are recommending that clients have the bulk of the anticipated plan drafting completed in the third quarter of 2008. With the basic plan drafting completed in the third quarter of 2008, the final quarter of 2008 can be reserved for making final adjustments after the full import of the changes in plan design are fully appreciated and it has been considered how the various plans work together. This is especially important where different departments of the company or different law firms have worked on different plans. One issue we have found is that amended plans often use different definitions of separation from service, change in control, or disability, or that the plans apply the six-month delay in different fashions or using different methods for determining the specified employee group. It is useful to have the fourth quarter of 2008 to consider the plans together as a whole and to consciously decide where consistency in definitions and approach between plans is desired.

Another task that should be completed before the end of the year is a final review of plan documents that were previously amended when the final regulations were first released last year. Issues continue to develop under section 409A and practitioners continue to develop best practices in section 409A plan design. Consequently, plans that were amended last year or even as
recently as earlier this year may not reflect the most current thinking on documentary compliance. For example, issues have arisen recently concerning section 409A compliance in the section 280G gross-up area. The issues involve both whether the six-month delay is required to be applied to such gross-up payments and whether so-called “cutback” provisions need to be amended to assure that they do not allow manipulation of the payment dates of the benefits that are not cutback. Practitioner thinking on these issues and how to draft around them has developed dramatically since many plans were first amended in 2007 and early 2008.

Although there is much to be done to have all plan documents and agreements compliant with section 409A by the end of 2008, taxpayers who have begun the process and even those who have not, but who take prompt action this summer, still should be able to meet the upcoming plan documentation deadlines.

Qualified Plans: Transfers to Puerto Rican Plans May Be Treated as Distributions and May Raise Disqualification Issues

Fred Oliphant & Veronica Rouse

On July 1, 2008, the IRS issued Revenue Ruling 2008-40, 2008-30 IRB, which clarifies the treatment of assets transferred from a qualified pension plan to a plan qualified under section 1165(a) of the Puerto Rico Internal Revenue Code (the “PRIRC”). The Ruling holds that transfers from a qualified plan under U.S. Internal Revenue Code section 401(a) to a PRIRC qualified plan and trust, including a PIRIRC plan that elects treatment under section 1022(i)(1) of ERISA, may be treated as transfers to a nonqualified plan, and hence as taxable distributions from the qualified plans (and not as plan-to-plan transfers). Moreover, in such instances, if such a distribution does not comply with the Code qualification rules governing the transferring plan (e.g., the rule prohibiting in-service distributions), it could raise qualification problems for the distributing plan. On the other hand, transfers from a qualified plan to a PRIRC plan that has made an election under ERISA section 1022(i)(2) are not treated as distributions (but rather as plan-to-plan transfers). The Ruling provides significant transition relief with respect to these holdings.

The Ruling points out that any retirement plan that covers Puerto Rican employees must satisfy the PRIRC requirements under section 1165(a), and that it may be difficult for a plan to satisfy both the Code and the PRIRC rules at the same time. Significant differences between the requirements of 401(a) of the Code and 1165(a) of the PRIRC include the definition of Highly Compensated Employee and contribution limits allowable under the plan. As a result, some employers have created a separate plan with a trust located in Puerto Rico that complies with section 1022(i) of ERISA but does not comply with section 401(a) of the Code. Sometimes plan assets representing the Puerto Rico employees’ participation in the plan are transferred to this new plan to make maintenance and compliance with the PRIRC easier. This employer action presents the question of how such transfers and the recipient Puerto Rican plan are to be treated under the Code, which the Ruling addresses.

ERISA Litigation: Kentucky Retirement Systems v. EEOC

Alan Horowitz & Josephine Harriott

The Supreme Court, in a 5-4 decision issued June 19, 2008, found that a state retirement plan does not unlawfully discriminate against older workers by crediting additional years of service to younger workers who do not have enough qualifying years of service when they become disabled. Kentucky Retirement Systems v. EEOC, No. 06-1037 (2008). Under the Kentucky retirement plan, a worker who becomes disabled after reaching the minimum age or years of service for standard pension benefits does not receive
The Age Discrimination in Employment Act of 1967 ("ADEA") makes it unlawful for an employer to discriminate against any individual because of the person’s age. 29 USC § 623(a)(1). The EEOC brought the action against Kentucky on behalf of a worker who, though he became eligible for retirement at age 55, continued working until he became disabled at age 61. Id. at 3. His benefits were based on his actual years of service, and no additional years were credited to him. Id.

The Court found that, while different treatment motivated by age violates the ADEA, different treatment based on pension status is not unlawful. Individuals who claim disparate treatment under a pension plan must show that the different treatment was motivated by age and not by pension status.


Tom Cryan & Adrian Morchower

The IRS and Treasury Department have issued final regulations that modify the process for making interest-free adjustments for both underpayments and overpayments of Federal employment taxes. The regulations also modify the process for filing claims for refund or credit of overpayments of such taxes. The regulations, which are effective on January 1, 2009, apply to any error ascertained on or after that date. The IRS has stated that it intends to issue guidance to provide examples of how the final regulations apply in different factual scenarios.

After the new regulations go into effect, interest-free employment tax adjustments that reflect reporting errors made for prior periods will no longer be treated as part of the liability for the current period in which the error is ascertained. Instead, for both underpayments and overpayments, adjustments will be made under the new rules by reporting the error on a separately filed adjusted return. For example, where the employer discovers an underpayment error after a return is filed, the employer must adjust the resulting underpayment of tax by reporting the additional amount due on an adjusted return for the period in which the wages or compensation were paid. The adjustment must be made by the due date of the return for the return period in which the error was ascertained and within the applicable period of limitations for assessments for such period. The amount of the underpayment must be paid at that time or interest will begin to accrue from that date and a penalty for failure to deposit may apply.

Generally, in the case of income tax withholding, an interest-free adjustment may be made only for errors ascertained during the calendar year in which the wages were paid. In addition, adjustments may be made in certain cases where the underpayment arises because the employer failed to file an original return (for example, where workers were not treated as employees) or failed to report and pay the correct type of tax (for example, where FICA tax was erroneously reported in lieu of RRTA tax).

It is expected that the interest-free employment tax adjustments will be made on a new Form 941X that, along with other forms, is being developed by the IRS to be used in conjunction with the new regulations. In addition, forms used to accept an assessment of employment taxes after an examination constitute adjusted returns for purposes of permitting the assessment to be treated as an interest-free adjustment. Employers may choose to file a claim for refund or credit in lieu of making an interest-free adjustment for an overpayment, and in some cases the employer may recover an overpayment only by filing such a claim.

Health & Welfare: New Form 5500 Guidance

Susan Relland
On July 14, the Department of Labor issued new Frequently Asked Questions (“FAQs”) regarding Schedule C of Form 5500. The guidance is intended to help plan administrators and service providers comply with the requirements for reporting service provider fees and other compensation. New final Form 5500 regulations were issued on November 16, 2007 and the regulations, along with this new guidance, apply to ERISA welfare and retirement plans. The requirements are generally effective for plan years beginning on or after January 1, 2009.

The following are a few of the issues addressed by the 40 new FAQs:

- Reporting on a plan or fiscal year basis;
- Reporting of charges for ordinary operational expenses;
- Reporting fees paid to record keepers;
- Alternate documents that may be used to satisfy the disclosure requirements; and
- The interaction between Schedule A and Schedule C reporting.

Additional guidance on both health and retirement plan Schedule C questions may be issued by DOL at a later date.

For further information, please contact any of the following lawyers:

Fred Oliphant, foliphant@milchev.com, 202-626-5834

Alan Horowitz, ahorowitz@milchev.com, 202-626-5839

Adrian Morchower

Josephine Harriott