

# Developments

March 10, 2003 to March 21, 2003

## IRS/DOL RULINGS, OPINIONS, ETC.

**Relief Granted to Correct Roth IRA Recharacterization.** In 2000, taxpayers converted their traditional IRAs to Roth IRAs. Their 2000 tax return was prepared by a CPA who did not inform them the conversion was improper, because their modified adjusted gross income exceeded the applicable \$100,000 limit. The company that prepared their 2001 tax return noticed the problem when reviewing the 2000 return. Relief has been granted to those taxpayers to convert the accounts back to traditional IRAs. The Internal Revenue Service (IRS) ruled the taxpayers had reasonably relied on a qualified tax professional when they made the improper election on their 2000 tax return. This is another in a series of private letter rulings granting relief to taxpayers who followed the IRS's required ruling procedure. Further discussion of these rulings is found in *Taxation of Distributions from Qualified Plans* written by members of the Hodgson Russ Employee Benefits Practice Group. [PLR 200310023.]

**Unused Vacation Pay Not an Employee 401(k) Contribution.** The IRS ruled contributions of amounts representing unused vacation pay accumulated during a year of employment do not constitute current taxable income to the affected employees and do not represent employee elective salary reduction contributions by the employees. Under the arrangement, unused vacation pay was not payable in cash and was forfeited if it was not contributed to the plan. The IRS held the contributions of unused vacation pay represented non-elective employer contributions to the qualified plan. The ruling did not address whether these employer contributions satisfied the discrimination tests applicable to employer contributions. Bear in mind the IRS's caveat that a private letter ruling may not be used as precedent. [PLR 200311043.]

**IRS Announces Continuation of Program to Find Non-Filers of Form 5500.** In the Spring 2003 edition of the IRS's *employee plans news* (<http://www.irs.ustreas.gov/pub/irs-tege/spr03.pdf>), the IRS stated it will continue its program to find employers who fail to file Form 5500. One technique the IRS is using is to review tax returns claiming a deduction for contributions to qualified plans and verify that a related Form 5500 has been filed. The IRS reminded employers that a self-correction program (the DFVC Program) is available to reduce penalties that would otherwise apply for failure to file Form 5500 on-time. The DFVC Program is available only if the sponsor has not been contacted in writing by the Department of Labor (DOL) regarding a late filing of Form 5500.

**FDA Warns Employer Plans Could Face Criminal Liability From Canadian Drug Importation.** Internet pharmacies, employer-sponsored health plans, pharmacy benefit managers, Canadian pharmacies, Canadian doctors, and health plan members all could be found criminally and civilly liable for violating food and drug laws by

aiding and abetting the importation of prescription drugs from Canada, according to an opinion letter from the Food and Drug Administration's (FDA) Office of Regulatory Affairs Imports. As prescription drug prices continue to soar and an expanded Medicare prescription drug benefit remains elusive, many U.S. consumers have turned to Canada as a source for lower-cost, price-controlled drugs. In addition, some health plans and insurers are interested in lowering costs by buying Canadian drugs. The FDA's opinion letter, dated February 12, was written in response to an inquiry brought by a New Orleans-based law firm representing health plans. "Virtually all shipments of prescription drugs imported from a Canadian pharmacy will run afoul of the [Federal Food, Drug, and Cosmetic] Act," William K. Hubbard, the FDA's associate commissioner for policy and planning, wrote in the opinion. Hubbard noted these drugs generally are unapproved, mislabeled, and/or dispensed without a valid prescription. A copy of the FDA's letter is available at <http://www.fda.gov/ora/import/kullman.htm>.

Carl Soller and C.J. Erickson, members of Hodgson Russ's Customs, Trade & Transportation Practice Group, are available to address any concerns you may have regarding this story. They may be reached at 718.244.8595.

## CASES

**Plan's "Wear Away" Provision Did Not Violate ERISA Nonforfeiture Rule.** The U.S. Court of Appeals for the First Circuit held ERISA's nonforfeiture provision applies only to accrued benefits, not to expected benefits of plan participants. The defendant, BankBoston, converted its defined benefit pension plan to a cash balance plan in 1989. At the time of conversion, the plan contained a provision for long-term employees that retirement benefits would at least equal those payable under the defined benefit plan formula. In 1997, BankBoston amended the cash balance plan to eliminate the continued accrual of benefits under the previous traditional defined benefit plan after December 31, 1996. The effect for some participants was that no additional accruals would be received until the new cash balance formula produced a greater benefit (also called a "wear away" approach). The court noted the 1996 plan amendment protected the pension benefit accrued by the plaintiff up to December 31, 1996, eliminating only the future expected accruals and did not result in an impermissible forfeiture of benefits. Bridgid K. Hurley of Hodgson Russ's Employee Benefits Practice Group worked extensively on this case on behalf of BankBoston while she was practicing in Boston. (*Campbell v. BankBoston N.A.*, 1st Cir., No. 02-1695, March 7, 2003.)

**Plan Held Not to Violate ERISA Anti-Cutback Rule.** The District Court for the Southern District of New York held a defined pension plan administrator did not violate the ERISA anti-cutback rule when it employed a "wear away" method to calculate benefits available to plan participants after the plan was amended to comply with the reduced limit on compensation under the 1986 Tax Reform Act (TRA '86). The

plaintiff alleged the plan's failure to employ an "additive" formula to calculate her benefits, instead of a "greater of" formula, violated the ERISA anti-cutback rules. The court held there was "no evidence in the record that the defendant's plan amendment was an 'add-on' formula, as plaintiff suggests; rather, all of the evidence in the record establishes that the plan was a 'replacement' formula." The court further commented that since 1981, the "greater of" method has been consistently approved by the IRS to prevent a decrease in a plan participant's accrued benefit. (*Brody v. Enhance Reinsurance Co. Pension Plan*, S.D.N.Y., No. 00 Civ. 9660 (LAP), March 14, 2003.)

**Bank Acted as Fiduciary Under ERISA.** In a 2-to-1 decision, the U.S. Court of Appeals for the Third Circuit held a bank went beyond being just a directed trustee and became an ERISA fiduciary when it took control of viatical settlement policy proceeds and erroneously distributed the proceeds to the incorrect plan. The bank, Frankford Trust Co., failed to discover the "double sale" of a viatical settlement policy to two retirement plans. The majority held the bank "acted as more than a 'plain vanilla' custodian of assets." (*Srein v. Frankford Trust Co.*, 3d Cir., No. 01-4516, March 13, 2003.)

**Grant-Date Value Disclosure for Director's Compensation Not Required.** A legal development in the world of stock option accounting: the U.S. Court of Appeals for the Ninth Circuit held proxy statements do not need to disclose the grant-date value of proposed stock options for outside directors to comply with Securities and Exchange Commission (SEC) requirements. A shareholder of Cisco Systems, Inc. filed a derivative suit alleging the company made materially false and misleading statements in breach of Section 14(a) of the Securities and Exchange Act of 1934 and SEC Rule 14a-9 because the company did not adhere to the Black-Scholes option pricing model in disclosing in its proxy statement the compensation payable to its outside directors. The court held while FASB No. 123, *Accounting for Stock-Based Compensation*, recommends recognizing the stock option's grant-date value as part of compensation expense in financial statements, the FASB statement does not purport to address the requirements of reporting proposed compensation in a proxy statement. (*Seinfeld v. Bartz*, 9th Cir., No. 02-15498, March 7, 2003.)

**Plan Amendment to Increase Benefits Could Constitute ERISA Fiduciary Breach.** The U.S. District Court for the Western District of New York held the defendants, trustees of a collectively-bargained, multi-employer pension fund, are not entitled to summary judgment because there are questions of fact as to whether amending a plan to increase benefits is an actionable breach of fiduciary duty. The plaintiffs allege the trustees breached their ERISA fiduciary duties by increasing benefits when the trustees knew the plan was in financial trouble. (*Burke v. Bodeves*, W.D.N.Y., No. 00-CV-65C, February 28, 2003.)

#### **Company Sued for Using Plan Assets to Pay Legal Fees.**

On March 12, 2003, the DOL filed a lawsuit in the U. S. District Court for the Northern District of Illinois seeking repayment of \$38,388 against Current Development Corp. (CDC), claiming the company used assets from its profit-sharing and money-purchase plans to pay legal fees incurred during litigation brought by the Employee Benefits Security Administration (EBSA). Three years ago, EBSA brought suit against CDC because the company failed to file annual reports as required by ERISA. An administrative law judge ruled in EBSA's favor in that case. DOL alleges plan trustee George P. Klein used plan assets to pay for the cost of legal defense and never repaid the plans. DOL is seeking sanctions against Klein, including permanently barring him from performing future trustee duties for this and other ERISA-covered plans. (*Chao v. Current Development Corp.*, N.D.Ill., No. 03 CV 1792, March 12, 2003.)

#### **Former CFO Charged with Sarbanes-Oxley Violation.**

Weston Smith, former chief financial officer of HealthSouth Corp., agreed to plead guilty to securities fraud charges. One of the criminal charges, filing false certification with the SEC, is believed to be the first such charge brought under the Sarbanes-Oxley Act. (*United States v. Smith*, N.D. Ala., Cr. No. 03-\_\_\_, plea entered March 19, 2003.)

#### **Pre-2002 New York State Compensation Plan Distributions Are Wages.**

The New York Tax Appeals Tribunal ruled plan distributions made in 1996 from the New York State Deferred Compensation Plan (a governmental Internal Revenue Code (IRC) § 457 plan) were wages, not payments of a pension or annuity, and therefore did not qualify for the pension or annuity exclusion under state tax law. The Appeals Tribunal affirmed the plan distributions were considered wages under IRC § 457(a), which provides any income from a state or local deferred compensation plan is includible in gross income. Because the distributions were wages under federal law, they also were not entitled to the \$20,000 exclusion under New York tax law for pensions and annuities. (*In re Flanter*, N.Y. Tax App. Trib., No. 818698, February 27, 2003.)

It should be noted the year in issue was prior to the amendment of IRC § 457(a) by EGTRRA effective January 1, 2002. Because the amendment allows a rollover to an IRA of amounts distributed from a governmental IRC § 457 plan, the New York Tax Department agrees that distributions from a governmental IRC § 457 plan after 2001 now qualify for exclusion. See Publication 36, New York State Department of Taxation and Finance.



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