EMPLOYEE BENEFITS

Developments

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AGENCIES

Final Golden Parachute Regulations Published With Procedure for Valuation of Stock Options. The Internal Revenue Service ("IRS") finalized the regulations that apply to "excess parachute payments" triggered by a change in ownership or of control ("change of control"). Excess parachute payments are subject to nondeductibility for a corporation under Internal Revenue Code ("Code") § 280G and an individual is subject to the 20% excise tax under Code § 4999. The regulations provide some relief business groups sought. For example, they clarified corporations that could be S corporations, but have not so elected, are exempt from the rules (as are S corporations). The determination of the 75% of voting power that must approve qualifying parachute payments is extended from three months before the change of control to six months. And, where multiple steps are involved in a change of control transaction, only one change is relevant. In several cases, changes business groups had sought were retained, according to the IRS, because the IRS was constrained by the statutory framework. For example, a parachute payment cannot be approved at the time the payment agreement is executed.

Of more interest, a companion revenue procedure finalizing the rules on valuation of stock options provides flexibility in valuing options for golden parachute purposes. The proposed rules focused on the Black-Scholes formula, considered by many to overvalue options. Among the liberalizing provisions in the revenue procedure is the ability to make adjustments for volatility 18 months after the change of control. The revenue procedure continues to prohibit use of only the option spread to value options for the "excess parachute" calculation.

The regulations apply to payments contingent on a change of control occurring after 2003. Until 2004 taxpayers can rely, with some caveats, on the 1989 and 2002 proposed regulations. (TD 8093; 68 Fed. Reg. 45,745 (Aug. 4, 2003), Treas. Reg. § 1.280G-1; Rev. Proc. 2003-68, 2003-__ IRB ___ (_____, 2003).)

IRS Continues Crackdown on Abuse of Variable Annuities and Life Insurance Contracts. We reported in the last issue that the IRS issued two revenue rulings regarding variable life and annuity contracts to clarify when the owner of a variable annuity or life insurance contract is, or is not, taxed as the owner of the contract's underlying assets for income tax purposes.

This past two weeks the IRS also issued proposed regulations to prevent taxpayers from turning otherwise taxable investments in hedge funds and other entities into tax-deferred or tax-free investments merely by purchasing them through a life insurance or annuity contract. Under the proposed regulations, look-through treatment would be available for interests in a nonregistered partnership only if all the beneficial interests in the nonregistered partnership are held by one or more segregated asset accounts of one or more insurance companies, and public access to these nonregistered partnerships is made available exclusively through the purchase of a variable contract. (Rev. Rul. 2003-91, 2003-33 IRB ___, Rev. Rul. 2003-92, 2003-33 IRB ___; Reg. 163974-02; 68 Fed. Reg. 44,689 (July 30, 2003), Prop. Reg. § 1.817-5.)

More Relief for Canadian RRSP Owners. The IRS provided further relief from reporting and penalties for Canadian registered retirement savings plans ("RRSPs"), registered retirement income funds ("RRIFs"), and other Canadian plans that are similar to U.S. individual retirement accounts ("IRAs"). For 2002, Notice 2003-57 relieves eligible taxpayers and plans from the trust-reporting requirements (Forms 3520 and 3520-A) if elections to defer U.S. income tax already have been made and certain other requirements are complied with. Penalty relief also is provided, even if the IRS requires additional information. And the time for filing the extension to defer U.S. income tax is extended for the 2002 year for six months after the due date (*without* extensions) of the tax return. (2003-34 IRB ____ (Aug. 25, 2003).)

Treasury Launches New Health Coverage Tax Credit Program. The Trade Act of 2002 created a new refundable federal health coverage tax credit for two groups: (1) trade-impacted workers who have lost their jobs due to increased imports or a shift in production to another country and who are classified as Trade Adjustment Assistance or Alternative Trade Adjustment Assistance eligible and (2) individuals whose pensions are being paid by the Pension Benefit Guaranty Corporation, are at least 55, and are not entitled to Medicare. The credit covers 65% of the cost of qualified health insurance for eligible individuals and their family members. On August 1, the IRS officially launched the Health Coverage Tax Credit program, allowing for advance payment of the credit to help pay insurance premiums as they come due. Eligible individuals, however, still may choose to receive the credit in a lump sum when filing their annual tax returns. Program registration guidance is set forth in a fact sheet issued by the IRS. (FS-2003-15 (August 1, 2003).)

First IRS Private Letter Ruling on Health Reimbursement Arrangements ("HRAs"). This ruling is remarkable not for what it says, but for what it indicates—that the IRS is willing to issue individual guidance in this fairly new area (private letter rulings cannot be relied on by taxpayers other than the one obtaining the ruling). The plan in this ruling met the basic requirements and had permitted features for these "defined contribution" health accounts that the IRS articulated in 2002 in a revenue ruling and notice, such as no employee contributions, reimbursements only for medical expenses that qualify under Code § 213(d), and carryforwards to the next year. Some of the more interesting features of the plan in this ruling are:

- "reverse discrimination" – more employer money contributed to the plan for lower-paid employees,
- a relationship between the amount the employer contributes and wages and personal exemptions (rather than the more common use of compensation), and

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- the availability of the aggregate reimbursement amount pro rata each payday (in contrast to a cafeteria plan's requirement of having the yearly amount available at all times during the year).

(Priv. Ltr. Rul. 200329014 (July 18, 2003).)

Compliance Guide Issued for Qualified Medical Child Support Orders ("QMCSOs"). The Department of Labor issued a new compliance guide for QMCSOs. The first section of the guide addresses general questions about QMCSOs. The second section addresses questions about National Medical Support Notices and the role of state child enforcement agencies in obtaining health care coverage on behalf of children. The final section provides additional resources and information about the Employee Retirement Income Security Act ("ERISA") and obtaining health care coverage and medical care for children. We remind you that plan administrators are required to have written procedures available for QMCSOs (and QDROs). Hodgson Russ's Employee Benefit Practice Group can assist you with these.

Happy Birthday to You, How Old Are You? A Child Attains Specific Age on Anniversary of Date Child Was Born. We can't wait for Dave Barry to get hold of this one. Yes, it took a revenue ruling to put this complex interpretation on the books for determining a child's age, for example for the dependency exemptions (Code § 151), dependent care credit (Code § 21), dependent care assistance programs (Code § 129), and other Code sections. But wait, *LEFT UNADDRESSED* are *LEAP YEAR* births! (Rev. Rul. 2003-72, 2003-__ IRB ___ (____, 2003).)

CASES

Courts Deal Heavy Blows to Cash Balance Plans. A federal district court found International Business Machines Corp.'s ("IBM") cash balance plan discriminates on the basis of age and violates ERISA, granting summary judgment on virtually every aspect of the case to the plaintiff employees. The case in the Southern District of Illinois is considered the most damaging to date to this defined benefit plan structure that tends to favor younger workers, compared to the traditional defined benefit plan that favors older workers. The IBM plan has a somewhat tortured history, involving more than one step, including a conversion from a traditional defined benefit plan to a "pension credit formula" plan that gave different results for employees of different ages who worked the same number of years and earned the same salaries, and a subsequent conversion to a cash balance plan formula. The Pension Rights Center hailed the case; business groups excoriated it. IBM quickly announced its intention to appeal the decision. The appeal will be to the Seventh Circuit, which a day after the IBM decision, in *Berger et al. v. Xerox Corp. Retirement Plan*, struck down one aspect of cash balance plan design. The *Berger* decision, written by a judge considered generally favorable to conservative and business interests, Richard Posner, not surprisingly struck down a method for determining the lump sum payable on a termination of an employee prior to retirement age (the so-called "anti-whipsaw" technique). The IRS and a Second Circuit court already held this method impermissible. Xerox Corp. announced it intends to seek a rehearing. We know of no businesses planning to change their existing cash balance plans, and some are going ahead with new ones, although we expect fewer new designs to be established while these cases are pending. Because of splits in the circuits and the economic effect of these cases, it is likely the issues in *Cooper*, at least, eventually may end up at the Supreme Court and will take more than a year to resolve. By the end of this year, the IRS is expected to issue final regulations on cash balance plans. Some practitioners believe a statutory fix (let Congress have a go at it) is needed. (*Cooper, et al. v. The IBM Personal Pension Plan*, S.D. Ill., No. 99-829-GPM, July 31, 2003; *Berger, et al. v. Xerox Corp. Retirement Plan*, No. 02-3674 (7th Cir., August 1, 2003).)

Court Holds QDRO has Priority Over IRS Tax Lien. The Eighth Circuit held a qualified domestic relations order ("QDRO") giving a plan participant's ex-wife a 90% interest in his employer-sponsored benefits has priority over a prior IRS tax lien on the same proceeds. Francis and Mary Taylor entered into a divorce agreement in July 1995 that provided Mary would receive a 90% interest in Francis's employee benefit proceeds at Northwest Airlines. A purported qualified domestic relations order (DRO) was issued by a Texas state court in July 1995, but was found by Northwest Airlines not qualified in October 1995. The IRS filed liens against the plan proceeds in December 1995 and October 1996. In January 1997, Northwest pronounced the DRO a QDRO. The federal appellate court reasoned in its ruling that because Mary was able to reform her court DRO into a QDRO within the required time of eighteen months pursuant to Code § 414(p)(7)(B) (and ERISA § 206(d)(3)(4)(ii)) and because the initial DRO was made before the IRS tax liens were entered, Mary was entitled to the plan proceeds free of the IRS tax lien, retroactive to the date of the initial order. (*U.S. v. Taylor*, 2003 WL 21755928 (8th Cir. July 31, 2003).)

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