THE NUTS AND BOLTS OF PENSIONS/BENEFITS

Rob Butterfield
Butterfield Schechter◆LLP

BUTTERFIELD
SCHECHTER ◆ LLP
ATTORNEYS &
COUNSELORS

10616 Scripps Summit Court, Suite 200
San Diego, California 92131-3966

858 444-ESOP (3767)
858 444-2200
Fax 858 444-2345
www.bsllp.com

I. MYTHS OF EGTRRA

1. 100% Deduction to Defined Contribution Plans Above Deferral Amount.

See "Uni-k" Discussion, but I sometimes hear from tax advisors the myth that a post-2001 Profit Sharing Plan's deduction limits are the lesser of $40,000 or 100% of compensation.

Actual Story: Deduction limit is 0-25% (20% for self-employed with base adjusted for 50% of FICA-Medicare) of net compensation up to $200,000, PLUS 401(k) deferrals.

Example: Profit Sharing Plan, 2002 calendar year, Owner made $200,000 net self-employment income, no 401(k) feature in Plan. Deduction calculated as follows:

1. $200,000.00
   7,941.95 minus 50% of FICA-Medicare
   $192,058.05

2. $192,058.05
   .20
   $ 38,411.61

Deductible contribution is $38,411.61.

Assume $50,000 net schedule C income –

$50,000.00
3,825.00
$46,175.00
.20
$ 9,235.00

Deductible contribution is $9,235

2. EGTRRA Allows "Deducting" Losses in IRAs, Profit Sharing Plans, etc.

EGTRRA allows post-2001 year deductions to most Defined Benefit Plans of an amount equal to their unfunded liability. This, in effect, allows deductions of contributions to make up for stock market deficiencies. This rule does NOT apply to IRAs and Defined Contribution Plans.

Comment: This should not be confused with the IRS position (discussed in Publication 590) that a taxpayer can close out all of his/her traditional IRAs (or Roth IRAs) and deduct – subject to the 2% AGI floor – the difference between his/her basis and the recovery.

Example: Joe contributes $2,000 per year to his traditional IRA on after-tax basis for 10 years. He has no other traditional IRAs. Account is now worth $10,000. He can close out IRA and deduct $10,000 on Form 1040 Schedule A, subject to the 2% floor.

TECHNICAL CORRECTIONS: Simplified Employee Plans – SEPs:

A. "Forgotten" in EGTRRA, IRC § 404(h)(1)(C) was amended during 2002 to put post-2001 SEPs at parity with post-2001 Profit Sharing Plans – i.e., 0-25% deduction limits (20% for self-employed). All references to the "2002 Act" are to the "Job Creation and Worker Assistance Act of 2002."

B. **Dollar limits for SEP eligibility, and for determining the distribution period from an ESOP, are increased to permit proper inflation indexing.**

Under pre-2002 Act law, the dollar amount that determines eligibility to participate in a SEP is $300 in compensation. The cost-of-living adjustments (COLAs) for 2002 raised this amount to $450. For an employee stock ownership plan (ESOP), distribution of the participant's account balance for participants with balances greater than $500,000 must be made not longer than five years plus one additional year for each $100,000, or fraction thereof, by which the account balance exceeds $500,000. The COLAs for 2002, made these amounts $160,000 and $800,000, respectively.

New law.

The 2002 Act applies the same COLA indexing method that applies to pension plan contribution limits. For SEPs, the $300 eligibility dollar amount is increased to $450. (Code Sec. 408(k) as amended by 2002 Act §411(j)(1)) For ESOPs, the $500,000 and $100,000 amounts used to calculate the ESOP distribution periods are increased to $800,000 and $160,000, respectively. (Code Sec. 409(o)(1)(C)(ii) as amended by 2002 Act §411(j)(2))

C. **Elective deferrals are no longer taken into account in applying SEP deduction limits for employer contributions.**

For purposes of the SEP deduction limit, under pre-2002 Act law, employee elective deferral contributions (as defined by Code Sec. 402(g)(3)) were treated as employer contributions and, thus, were subject to the generally applicable deduction limit.

New law.

Under the 2002 Act, elective deferrals made to a SEP are not subject to the deduction limits and are not taken into account in applying the limits to other SEP contributions. (Code Sec. 404(n) as amended by 2002 Act §411(l)(2))

D. **"Compensation" for purposes of determining deduction limits for contributions to SEPs includes salary reduction amounts.**

Under pre-2002 Act law, "compensation" for purposes of determining deduction limits for contributions to SEPs generally did not include salary reduction amounts.

New law.

Under the 2002 Act, the definition of "compensation" for purposes of the limitation on deductions for contributions to SEPs includes amounts treated as a participant's compensation under Code Sec. 415(c)(3)(C) or Code Sec. 415(c)(3)(D). (Code Sec. 404(a)(12) as amended by 2002 Act §411(l)(1))

E. **Deduction limit for combined plans doesn't apply if defined contribution plan receives only elective deferrals.**

Subject to certain limits, employer contributions to qualified retirement plans are deductible. Under pre-2002 Act law, where an employer maintained both a defined benefit plan and a defined contribution plan, the Code Sec. 404(a)(7)(A) combined limit on deductions applied, even though the only amounts contributed to the defined contribution plan were employee elective deferrals.

New law.

Under the 2002 Act, the deduction limit on combinations of defined benefit and defined contribution plans do not apply where no amounts (except for elective deferrals) are contributed to any of the defined contribution plans for the taxable year. (Code Sec. 404(a)(7)(C)(ii) as amended by 2002 Act §411(l)(4))

F. **Individuals who reach age 50 by the end of the tax year are eligible to make catch-up contributions as of the beginning of the year.**

Under EGTRRA, applicable employer plans can allow individuals who have reached age 50 to make additional "catch-up" elective contributions, up to the "applicable dollar amount."

New law.

Under the 2002 Act, an eligible participant is a plan participant who would attain age 50 by the end of the tax year. (Code Sec. 414(v)(5)(A) as amended by 2002 Act §411(o)(7)(B)) Thus, an individual who will reach age 50 by the end of the tax year can be an eligible participant as of the beginning of the tax year, rather than only at his 50th birthday. (Code Sec. 414(v)(5)(B) as amended by 2002 Act §411(o)(7)(C))

Also, under the 2002 Act, an eligible participant is a plan participant for whom, because of specified limitations, no other elective deferrals may be made (but for the catch-up contribution rules) for the plan year or other applicable year.

G. **Additional elective deferrals that don't exceed catch-up contribution limit are excludable from eligible participant's income.**

Before the 2002 Act, the catch-up contribution rules in Code Sec. 414(v) did not specify that catch-up contributions are excludable from income.

New law.

Under the 2002 Act, elective deferrals that exceed the otherwise applicable Code Sec. 402(g) limit ($11,000 for 2002) are excludable from income to the extent that they don't exceed the applicable dollar amount under the catch-up contribution rules for the tax year. (Code Sec. 402(g)(1)(C) as amended by 2002 Act §411(o)(1))

H. **Plan's catch-up contribution limit must be applied on an aggregate basis, using the controlled group rules.**

A plan must not permit catch-up contributions for any year in an amount greater than the "applicable dollar amount." According to Prop Reg § 1.414(v)-1, if elective deferrals under more than one applicable employer plan of an employer are aggregated for purposes of applying a statutory limit, the aggregate of the elective deferrals treated as catch-up contributions by reason of exceeding that statutory limit under all of these applicable employer plans, must not exceed the applicable dollar limit for the tax year.

New law.

Under the 2002 Act, for purposes of determining the limitation on the amount of catch-up contributions that a plan can permit, the following plans maintained by the same "employer" are treated as a single plan: (1) a Code Sec. 401(a) qualified plan; (2) a Code Sec. 403(b) tax-sheltered annuity; (3) a Code Sec. 408(k) simplified employer pension (SEP); and (4) a Code Sec. 408(p) SIMPLE IRA plan. For this purpose, an "employer" is determined under the controlled group rules under Code Sec. 414(b) (for a controlled group of corporations), Code Sec. 414(c) (for a group of partnerships, etc., under common control), and affiliated service groups (under Code Sec. 414(m)), and regs IRS issues under Code Sec. 414(o).

I. **Governmental section 457 plan participants can make catch-up contributions equal to the greater of the amount allowed under Code Sec. 414(v) or under Code Sec. 457.**

Under pre-2002 Act law, during the three final tax years ending before he reached normal retirement age, a governmental eligible deferred compensation (section 457) plan participant would not have been allowed to make Code Sec. 414(v) catch-up contributions under a governmental section 457 plan—even in a year when the Code Sec. 414(v) catch-up rules would have allowed a greater amount of elective deferrals than the catch-up rules for section 457 plans (under Code Sec. 457(b)(3)).

New law.

Under the 2002 Act, a participant in a governmental section 457 plan can make catch-up contributions in an amount equal to the greater of: (1) the amount permitted under the Code Sec. 414(v) rules, and (2) the amount permitted under the Code Sec. 457 plan rules (including the Code Sec. 457 catch-up rules).

J. **List of qualification requirements that don't apply to catch-up contribution is revised.**

A plan can allow eligible participants to make catch-up contributions without regard to various qualification requirements or limitations that ordinarily apply to "elective deferrals," and without having those catch-up contributions taken into account in applying certain requirements. Also, just because an applicable employer plan allows a catch-up eligible participant to make catch-up contributions, doesn't mean the plan will be treated as failing specified nondiscrimination requirements.

New law.

The 2002 Act revises the list of qualification requirements that don't apply to catch-up contributions, to read as follows:

- the exclusion for elective deferrals (under Code Sec. 401(a)(30));
- contributions to SEPs (under Code Sec. 402(h));
- tax-sheltered annuities (under Code Sec. 403(b));
- IRAs, SEPs, and SIMPLE plans (under Code Sec. 408);
- plan contributions (under Code Sec. 415(c)); and
- deferrals under section 457 plans (under Code Sec. 457(b)(2), determined without regard to Code Sec. 457(b)(3)). (Code Sec. 414(v)(3)(A)(i) as amended by 2002 Act §411(o)(4))

The 2002 Act also revises the list of nondiscrimination rules that a plan won't be treated as failing to meet because of allowing catch-up contributions, to read as follows:

- the Code Sec. 401(a)(4) nondiscrimination rules;
- the actual deferral percentage (ADP) test for CODAs (under Code Sec. 401(k)(3));
- the SIMPLE 401(k) plan rules (under Code Sec. 401(k)(11));
- the nondiscrimination test for tax-sheltered annuities (under Code Sec. 403(b)(12));
- the SEP rules (under Code Sec. 408(k));
- the minimum coverage requirements (under Code Sec. 410(b)); and
- the top-heavy plan rules (under Code Sec. 416).

K. **Qualified plan distributions that are rolled over are treated as consisting first of taxable amounts.**

For distributions made after 2001, under EGTRRA, an individual is allowed to roll over the nontaxable portion of an eligible rollover distribution to specified eligible retirement plans.

New law.

Under the 2002 Act, for amounts that were rolled over that consisted of both (i) amounts that would have been includible in income but for the rollover (taxable amounts), and (i) amounts that would have not have been includible even if they had not been rolled over (nontaxable amounts), the amount transferred is treated as consisting first of the portion of the distribution that is includible in income (determined without regard to the rollover exclusion). (Code Sec. 402(c)(2) as amended by 2002 Act §411(q)(2))

L. **Direct rollovers of after-tax amounts from qualified retirement plans can be made only to defined contribution plans (and IRAs).**

Under EGTRRA, the direct rollover rules apply to the nontaxable portion of an eligible rollover distribution (as well as to the taxable portion)—but only if the plan to which the distribution is transferred: (1) agrees to separately account for amounts transferred, including a separate accounting for the portion of the distribution which is includible in gross income and the portion which is not includible in gross income, or (2) is an IRA.

New law.

The 2002 Act clarifies that a qualified retirement plan must allow the distributee of an eligible rollover distribution to elect to have the nontaxable portion of

the distribution transferred in a direct rollover to a plan that meets the separate accounting requirements, but (unless the transferee plan is a traditional IRA) only if the transferee plan is a qualified trust which is part of a plan which is a defined contribution plan. (Code Sec. 401(a)(31)(C)(i) as amended by 2002 Act §411(q)(1))

M. **Retirement contributions that qualify for saver's credit must be reduced by nontaxable distributions from qualified retirement plans, deferred compensation plans, or traditional IRAs.**

Under pre-2002 Act law, an individual's qualified retirement savings contributions had to be reduced by the sum of: (1) any distribution from a qualified retirement plan or eligible deferred compensation plan received by the individual during the testing period that is includible in gross income, and (2) any distribution from a Roth IRA or a Roth account received by the individual that isn't a qualified rollover contribution.

New law.

Under the 2002 Act, an individual's qualified retirement savings contributions for purposes of the saver's credit must be reduced by the aggregate distributions received by the individual during the testing period from any entity of a type to which qualified contributions may be made. (Code Sec. 25B(d)(2)(A) as amended by 2002 Act §411(m))

N. **Rules applying defined contribution plan limits to Code Sec. 403(b) annuities, Code Sec. 457 plans and church plans are clarified.**

EGTRRA conformed the contribution limits for 403(b) annuities to the limits applicable to other retirement plans.

New law.

The 2002 Act clarifies that the contribution limits apply to contributions to a 403(b) annuity in the year that the contributions are made, without regard to when the contributions become nonforfeitable, and that contributions to a 403(b) annuity may be made for an employee for up to five years after retirement. (Code Sec. 403(b)(1) as amended by 2002 Act §411(p)(1); Code Sec. 403(b)(3) as amended by 2002 Act §411(p)(3))

The 2002 Act restores special rules for ministers, lay employees of churches and foreign missionaries. Thus, the 2002 Act restores the rule that for purposes of plan contributions by church plans all years of service by a minister, or lay employee, with a church, or with a convention or association of churches, or with a church-related organization are treated as service for one employer. (Code Sec. 415(c)(7)(B) as amended by 2002 Act §411(p)(4))

The 2002 Act conforms the definition of "compensation" used to apply the limits to a Section 457 plan to the definition used for defined contribution plans. (Code Sec. 457(e)(5) as amended by 2002 Act §411(p)(5))

UNI-k

One of most striking and popular techniques originating out of EGTRRA is the "Uni-k." This is a "single person" – or "married couple" 401(k) Plan. Not useful prior to EGTRRA, the utility of this approach is illustrated as follows:

1. Single Participant I:

   $100,000 salary (corporate employee)
   $ 25,000+ corporate profit in addition to salary

   $11,000 Deferral ($1,000 more if 50+)
   $25,000 Contribution
   $36,000 Deduction (36% of salary)

2. Single Participant II:

   $30,000 salary (corporate employee for FICA savings)
   $11,000 Deferral ($1,000 more if 50+)
   $ 7,500 Contribution
   $18,500 (61.6% of salary)

3. Married Participants:

   A. $100,000 Salary
      $ 36,000 Deduction

   B. $15,000 Salary

      $11,000 Deferral
      $ 3,750 Contribution
      $14,750

   Total Deduction: $50,750 (44.13% of salaries)

2002 Hot Benefit Topics – Myths

I. VEBA Deduction Limits

Insurance sales people often need "sexy wrappers" to sell life insurance. One of the most aggressive over the past few years has been the Multi-Employer Welfare Plan intended to qualify for the "more than 10 employer" exception from IRC § 419A's strict deduction limits.

Typical Scenario: Insurance/benefit advisor indicates there is a fantastic deduction opportunity under a program that requires little or no employee coverage, but promises large deductions to the employer. Your money will go into your own life insurance policy, or account, and that policy or account is yours eventually, with the performance of that policy being yours. They explain there is some "window dressing" risk that your funds could be part of some overall "pool" of risks, but that "don't worry" - your own policy is safe and secure - its "yours."

Recent Developments Have Belied This!

A. IRS Proposed Regulations. On July 11, 2002 the IRS issued proposed regulations about this type of VEBA. Excerpts from a discussion about the regulations in RIA follow:

"**Notice 95-34.**

In 1995, IRS issued Notice 95-34, 1995-1 CB 309, in response to what IRS determined to be abusive marketing tactics on the part of promoters of trust arrangements aimed at small business organizations—typically, professional service corporations—that the promoters claimed met the 10 or more employer exemption. The promoters typically claimed that their arrangements allowed the businesses to take current tax deductions for premiums paid on variable or universal life insurance products on the lives of the covered employees in order to provide funding for life insurance, disability, and severance benefits, even though the premiums paid bore little relationship to the current cost of providing the promised benefits.

Notice 95-34 identified certain types of these arrangements that do not satisfy the requirements of Code Sec. 419A(f)(6), as, for example, an arrangement providing deferred compensation; an arrangement that may be separate plans maintained for each employer; or a plan that may be maintaining, in form or in operation, the experience-rating arrangements with respect to individual employers—all items that would defeat the promoters' claims for exemption. The notice also stated that, even if an arrangement satisfies the requirements of Code Sec.419A(f)(6), so that the deduction limits of Code Sec. 419 and Code Sec. 419A do not apply to the arrangement, the employer contributions could represent expenses that are not deductible under other sections of the Code. (Notice 95-34, 1995-1 CB 309).

The proposed regs.

The proposed regs under Code Sec. 419A(f)(6) focus in detail on the criteria that must be met—both in form and in substance—before a particular welfare benefit arrangement would be considered as meeting the 10 or more employer test under Code Sec. 419A(f)(6) .

General requirements.

The proposed regs echo the statutory provision under Code Sec. 419A(f)(6) and provide that the exception applies only if the plan is a single plan: (i) to which more than one employer contributes; (ii) to which no employer normally contributes more than 10% of the total contributions contributed under the plan by all employers; and (iii) that does not maintain an experience-rating arrangement with respect to any individual employer. In addition, the proposed regs add that the plan also would have to satisfy the compliance information requirement discussed below. (Prop Reg § 1.419A(f)(6)-1(a)(1))

Compliance information.

In addition to the statutory requirements, in order to qualify for the 10-employer exemption, a plan would have to be maintained under a written document that (a) requires the plan administrator to maintain records sufficient for IRS or any participating employer to verify readily that the plan satisfies the requirements of Code Sec. 419A(f)(6) and Prop Reg § 1.419A(f)(6)-1, and that (b) provides IRS and each participating employer (or a person acting on the participating employer's behalf) with the right, upon written request to the plan administrator, to inspect and copy all such records. (Prop Reg § 1.419A(f)(6)-1(a)(2))

What material is taken into consideration.

For purposes of Prop Reg § 1.419A(f)(6)-1, the term “plan” includes the totality of the arrangement and any related facts and circumstances, including any relevant insurance contracts. Therefore, all agreements and understandings **(including promotional materials and policy illustrations)** and the terms of any insurance contract involved in providing benefits under the arrangement would be considered in determining whether the requirements are satisfied in form and in operation. (Prop Reg § 1.419A(f)(6)-1(a)(3)(ii))

Whether a plan experience-rates employers.

In general, a plan would be considered as impermissibly maintaining an experience-rating arrangement with respect to an individual employer if there is any period for which the relationship of contributions under the plan to the benefits or other amounts payable under the plan (i.e., the cost of coverage) is or can be expected to be based, in whole or in part, on the benefits experience or overall experience of that employer or one or more employees of that employer. For these purposes, an employer's contributions would

include all contributions made by or on behalf of the employer or the employer's employees. (Prop Reg § 1.419A(f)(6)-1(b)(1))

In this context, the "benefits experience" of an employer (or of an employee or a group of employers or employees) would mean the benefits and other amounts incurred, paid, or distributed (or otherwise provided) directly or indirectly with respect to the employer (or employee or group of employers or employees), regardless of whether provided as welfare benefits, cash, dividends, credits, rebates of contributions, property, promises to pay, or otherwise. (Prop Reg § 1.419A(f)(6)-1(d)(2))

Examples of a plan that the proposed regs would find as maintaining an experience-rating arrangement with respect to an individual employer include a plan:

- that entitles an employer to a reduction in future contributions if that employer's overall experience is positive;
- under which an employer's future contributions may be increased if the employer's overall experience is negative; and
- under which the employer could receive a rebate of all or a portion of its contributions if that employer's overall experience is positive or, conversely, where an employer is liable to make additional contributions if its overall experience is negative. (Prop Reg § 1.419A(f)(6)-1(b)(2))

Likewise, the proposed regs would consider as maintaining an experience-rated arrangement any plan:

- under which benefits for an employer's employees could be increased if that employer's overall experience is positive, or under which benefits could be decreased if that employer's overall experience is negative; and
- under which benefits for an employer's employees are limited by the overall experience of the employer (rather than having all the plan assets available to provide the benefits). (Prop Reg § 1.419A(f)(6)-1(b)(3))

Treatment of insurance contracts, premiums, and benefits.

For purposes of Prop Reg § 1.419A(f)(6)-1, insurance contracts held under the arrangement would be treated æs assets of the fund. Thus, the value of the insurance contracts (including any nonguaranteed elements) is included in the value of the fund, and amounts paid between the fund and the insurance company are disregarded unless they generate gains or losses to the fund—i.e., insurance contract benefits that are more or less than the premiums paid to the insurer for the coverage. (Prop Reg § 1.419A(f)(6)-1(b)(4)(i)(A))

Payments from a participating employer or its employees to an insurance company pursuant to insurance contracts under the arrangement would be treated as contributions made to the fund, and amounts paid under the arrangement from an insurance company would be treated as payments from the fund. (Prop Reg §

1.419A(f)(6)-1(b)(4)(i)(B)) For the sole purposes of determining the cost of coverage under a plan, if contributions for any period could vary with respect to a particular benefit package, IRS could treat the employer as contributing the minimum amount that would maintain the coverage for that period. (Prop Reg § 1.419A(f)(6)-1(b)(4)(ii))

Experience rating by groups.

A plan would not be treated as maintaining an experience-rating arrangement with respect to an individual employer only because the cost of coverage under the plan with respect to the employer is based wholly or partially on the benefits experience or the overall experience of a rating group—i.e., a group of participating employers that includes the employer or a group of employees covered under the plan that includes one or more employees of the employer—provided that no employer normally contributes more than 10% of all contributions with respect to that rating group. (Prop Reg § 1.419A(f)(6)-1(b)(4)(iii))

Characteristics indicating a plan does not qualify for the exemption.

The proposed regs enumerate the following characteristics, any one of which generally would indicate that a plan is not a 10 or more employer plan described in Code Sec. 419A(f)(6) (although the absence of any of these factors would not create the inference that a given plan meets the requirements for the exemption):

- the assets of the plan or fund are allocated to a specific employer or employers through separate accounting of contributions and expenditures for individual employers;
- the amount charged under the plan is not uniform for all of the participating employers, and any differences are not reflective of differences in risk or rating factors that are commonly taken into account in manual rates used by insurers (e.g., age, gender, geographic locale, number of covered dependents, and benefit terms) for the particular benefit or benefits being provided;
- the plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost;
- the plan provides for fixed welfare benefits for a fixed coverage period for a fixed cost, but that cost is unreasonably high for the covered risk for the plan as a whole; and
- benefits or other amounts payable can be paid from a fund that is part of the plan by reason of any event other than the illness, personal injury, or death of an employee or family member, or upon the employee's involuntary separation from employment, e.g., where the plan provides for the payment of benefits to an employer's employees on the occasion of the employer's withdrawal from the plan. (Prop Reg § 1.419A(f)(6)-1(c)(2) –(6))

Proposed effective date.

The proposed regs would be effective with respect to contributions paid or incurred in taxable years of an employer beginning on or after July 11, 2002. For contributions made before this proposed effective date, IRS will continue applying existing law, including the analysis set forth in Notice 95-34 and any relevant case law. Accordingly, taxpayers should not infer that a contribution that would be nondeductible under the proposed regs would be deductible if made before that date. (Prop Reg § 1.419A(f)(6)-1(g)(1))

The requirement that written plan documents contain specified provisions relating to compliance information and the record maintenance requirement for plan administrators would be effective for taxable years of a welfare benefit fund beginning after the publication of final regs. Existing record retention requirements and record production requirements under Code Sec. 6001 continue to apply to employers and promoters. (Prop Reg § 1.419A(f)(6)-1(g)(2) ; Prop Reg 1.419A(f)(6)-1)."

B. Insurance and Investment Risk: The policies are normally heavily loaded, and trustees and promoters of these VEBAs have been known to (a) charge high fees to the funds, (b) provide specious over inflated illustrations of future policy performance and (c) speculate with the trust funds (I worked with one trustee—after the fact—who hedged the trust fund and lost 90%+ of it).

C. U.S. Tax Court Case Upheld. The U.S. Court of Appeals (Third Court) upheld the U.S. Tax Court's 2001 determination. The "head notes" in the American Federal Tax Reports says:

"**1. Business deductions—voluntary employees' beneficiary association (VEBA) plan contributions—constructive distributions—deductions for amounts paid in connection with insurance—indirect beneficiary.** Tax Court properly determined that closely held professional medical corps.' Excess VEBA plan contributions for group term life ins. that widely exceeded conventional ins. Costs were disguised surplus cash distributions and not deductible Code Sec. 162 ordinary and necessary business expenses: record showed transactions were really just bookkeeping artifice using inflated premiums as means for achieving bogus tax benefits. Notable, payments exceeded conventional ins. by almost 500% and merely paid for "conversion credits" rather than actual current year ins. payments; and taxpayers' education and training belied any claim that they bought admittedly overpriced ins. with no expectation of tax benefit in return. Also, taxpayers' reliance on ERISA case law for proposition that Court should not have looked to documents outside plan and ins. contracts was misplaced; and argument that ins. law otherwise mandated Court's limited document review was rejected.

2. Gross income—constructive dividends—excess VEBA plan contributions—business deductions—ordinary and necessary—covered employees—time for reporting income—forfeiture. Tax Court properly determined that employee-owners received constructive dividends, not deductible compensation, from closely held professional medical corps.' excess VEBA plan contributions for group term life ins. that widely exceeded conventional ins. costs; dividend finding was supported by transactions' very design, lack of any compensatory intent and failure to offer plans to non-equity employees; and taxpayers' reliance on ERISA case law for proposition that plan payments were compensation per se was misplaced.

3. Penalties—accuracy-related negligence; failure to timely file returns—reasonable cause—reliance—test case—frivolous claim penalties—litigating positions—actions of trial attorneys—VEBA plans. Tax Court properly upheld accuracy-related negligence penalties against owners of closely held medical corps. that mischaracterized excess VEBA plan contributions for nonconventional life ins. as deductible business expenses: taxpayers' reliance on insiders wasn't reasonable; and, although 1 taxpayer consulted his own accountant, he didn't show what information or advice was exchanged with accountant or identify accountant's qualifications. Also, as highly educated professionals, taxpayers should have recognized too-good-to-be-true nature of scheme that promised both large corp. deductions and tax-free income to them individually; and "test case" argument was rejected."

D. IRS Deduction Risk: See Court Case and regulations described above. Part of this is "audit lottery" stuff, but the IRS has been disallowing deductions to VEBAs whenever they can identify an appropriate situation. Some insurance/benefit advisors play the "audit lottery game" but rarely tell the customer that is what they are doing. Do you want to practice accountancy that way? Doubt it!

II. Internal Revenue Code Section 412(i)

IRC § 412(i) provides an exception to "minimum funding" rules for fully insured defined benefit plans. Some insurance agents benefit advisors/accountants have, in recent months, been advising 412(i) plans as the answer to a (lack of) deduction problem.

Claims.

1. Deductions are significantly higher than a noninsured defined benefit plan.

2. The investment is secure.

3. Distributions when receiving benefits are based solely on cash surrender value, allowing statements such as "you can fund $200,000 per year for 5 years—then terminate plan and take it out with only $80,000 of taxable income because that is the cash value."

4. You can deduct based on a 3% or 4% assumed interest rate instead of 5% or more.

Reality. I represented more than 1 taxpayer in the late 1980's and early 1990's in IRS attacks on 412(i) plans. They have "resurfaced" —perhaps due more to an audit lottery mentality then reality:

1. Distributions of a "springing cash value" policy (see below) is not necessarily based on cash surrender value.

2. IRC § 415 limits are based on a 5% rate—not 3% or 4%.

3. Employees' cost can be significant—and the "top-heavy" minimum benefit must continue to be provided—costing a lot if you are using artificially depressed cash value policies.

4. Most of the policies pitched under this approach are less than stellar—high loads, low cash value for many years. Thus, higher deduction offset by lesser performance over the years—not to mention a horrible result if you need to cash in an artificially low cash value policy before it "springs" back to life.

Comment: Old timers like me remember IRS Notice 89-25 Question 10. It is repeated as follows:

"Q-10: What amount is included in a plan participant's gross income when the participant receives a distribution from a qualified plan that includes a policy issued by an insurance company with a value substantially higher than the cash surrender value stated in the policy?

A-10: Subject to certain exceptions not here applicable, Section 402(a) of the Code provides that the amount actually distributed by a qualified employees' trust shall be taxable to a plan participant in the year in which so distributed under section 72 (relating to annuities). Section 1.402(a)-1(a)(1)(iii) of the regulations provides that the amount includible in a plan participant's gross income by reason of the distribution of property by the plan shall be the fair market value of such property. Life insurance contracts constitute property within the meaning of this section. Section 1.402(a)-1(a)(2) of the regulations provides that a distributee must include in gross income the cash value of any retirement income, endowment, or other life insurance contract at the time of the distribution. Section 1.72-16(c)(2)(ii) of the regulations indicates that the reserve accumulation in a life insurance contract constitutes the source of and approximates the amount of such cash value.

Individuals who receive an insurance policy as a distribution from a qualified plan use the stated cash surrender value of the policy as its fair market value for purposes of determining the amount includible in their gross income under section 402(a) of the Code. However, this practice is not appropriate where the total policy reserves, including life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value. These circumstances are illustrated by the following example.

A is a participant in a qualified noncontributory defined benefit plan. On January 1, 1986, $400,000 of plan assets were used to purchase an insurance policy. The policy was distributed to A on January 1, 1988, two years after the date of purchase.

The policy provides a stated cash surrender value for each of the first five policy years, as set forth in the table below. The total end of year reserves held by the insurance company for the policy also are set forth in the table. These reserves may include life insurance reserves and any reserves for advance premiums, dividend accumulations, etc. Life insurance reserves, if any, are calculated using the rules in Section 807(d) of the Code, which provides rules for determining the amount of those reserves for purposes of calculating the tax liability of the insurance company issuing the policy.

Year	Surrender Value	Reserves
1	$106,000	$406,949
2	$112,360	$426,596
3	$119,102	$447,052
4	$126,248	$468,178
5	$489,908	$489,908

As the total reserves for the policy at the end of year two, $426,597, substantially exceed the policy's cash surrender value, $112,360, the reserves represent a much more accurate approximation of the fair market value of the policy when distributed than does the policy's cash surrender value. Accordingly, the amount includible in A's gross income by reason of the distribution of the policy at the end of year two is an amount equal to the $426,597 reserve, not the $112,360 stated cash surrender value at that date.

In the case of a distribution in excess of A's accrued benefit, as defined in section 1.411(a)-7(a)(1) of the regulations, resulting from valuing the policy at $112,360 rather than $426,547, the distribution would not be treated as a distribution to A from a qualified plan and, depending upon the facts and circumstances of the case, could be treated as a reversion to the employer. Of course, depending on the facts and circumstances, such distributions could disqualify the plan because they raise a number of qualification issues under, for example, Section 415 of the Code, limitations on benefits and contributions, Section 401(a) requirements that benefits be definitely determinable, and Section 401(a)(4), discrimination in contributions and benefits, particularly if A was a member of the group of employees in whose favor discrimination is prohibited and other employees were not provided with similar distributions."

III. Section 79 Group Life Insurance Programs.

Some insurance advisors are promoting the incredible scenario of large current corporate deductions for permanent coverage under a Group Life Program under IRC § 79. Let's look at that.

A. First $50,000 of term coverage under a nondiscriminatory group life program is tax free. This has been perceived as a small tax benefit- i.e. how much can $50,000 of term insurance cost for most clients under age 50? Table I in regulations specifies the attributable cost, based on 5 year brackets.

Example. A 45 year old with $1,000,000 coverage. Table I costs is $90, so $90 is a nontaxable benefit- $1,710 is taxable.

B. Assume insurance is provided as permanent coverage. Some agents are claiming deductions of as high as $40,000 - $50,000 annually- with no tax costs to the employee from that- claiming they have a "specially designed policy" that qualifies for special treatment under Section 79. I have heard a scenario where employee contributes $50,000, corporation pays $50,000- and the employee gets no tax hit on the $50,000 corporate tax deductible payment into a permanent policy owned by the employee.

Comment: The Regs specify a precise, if complicated, method to determine the amount of taxable benefit to the employee (see Reg Section 1.79-1). There is an arbitrage due to the Regs' specification of a 1951 Commissioners Table, BUT I see nothing in the Regs to support the claimed deductions, nor does it appear any "specially designed policy" makes any difference in the calculation under the Regs. There may be some marginal benefit in this arbitrage, but weighed against that is the "cost" of the policy- particularly a policy that is said to intentionally have low cash value in its early years.

New Small Plan Bonding/Accountant Audit Rules.

U.S. Department of Labor Regulations §2520.140-46 (10-19-2000) – The "small plan" (under 100 participants) CPA audit exception is not automatic anymore.

Prior Regs exempted all small plans from audit requirements. Regs, effective for Plan Years beginning after April 17, 2001, are not so generous. Exemption for small plans applies only if:

(1) 95% of plan assets are "qualifying plan assets" – or

(2) Any person handling non-qualified assets is bonded. The amount of the bond must equal the face value of non-qualifying assets."

"Qualifying Plan Assets" are:

1. Qualifying employer securities under ERISA §407(d)(5)
2. Loans to Participants that meet ERISA §408(b)(1) (adequately secured, bear interest)
3. Assets held by bank or similar institution
4. Assets held by insurance company
5. Assets held by registered broker dealer
6. Assets held by any organization authorized to act as an IRA custodian
7. Mutual funds
8. Investment and Annuity Contracts issued by an insurance company
9. Individual Directed Accounts held by a regulated financial institution.

Not QPAs (unless held in a bank trusteed earmarked account) are limited partnerships, real estate, trust deeds, loans to nonparticipants, etc.

What is the problem? Bond should be in place the entire plan year to gain the exemption. All 2002 Plan Years are affected. Plan Years beginning on or after May 1, 2001, were also affected. We have found only one surety company willing to issue 100% bonds for a nominal fee (example $379 for $300,000 of coverage for 3 years) and the maximum bond limit is $500,000. Bonds can – for an added fee – be retroactive to the beginning of the affected Plan Year.

Example - Profit Sharing Plan has $3,000,000 and 20 participants. No bank trustee. Individual Earmarked Accounts have $1,000,000 in real estate, limited partnerships and trust deeds. Plan year begins December 1, 2001. Plan must obtain at least a $1,000,000 bond by December 1, 2001 or secure a CPA audit for the plan year ending November 30, 2002. Source of bonds over $500,000 is limited and expensive (we saw quotes for $5.00 per $1,000 of coverage).

Alternatives? If bond is unavailable or too costly – consider alternative of terminating plan before the rule's effective date (not possible unless Plan Year ends after today) and rolling offending "non-qualified assets" to single participant frozen Money Purchase Pension Plans, or perhaps an IRA (if you can find a suitable custodian and creditor protection is of less concern), or taking other appropriate (make sure you are in compliance with other qualification rules) action to sell or distribute Non-QPAs from the plan. Or arrange for a bank trustee.

EGTRRA Notice and Other Notices When Reducing Benefits or Terminating Plan.

Draconian EGTRRA Requirements. IRC §4980F.

1. Congress took offense to "cash balance" conversions of Defined Benefit Plans (a "cash balance plan" is a defined benefit plan that tends to reduce future accruals of older participants when compared to "traditional" Defined Benefit Plans).

2. For Plan amendments taking effect after EGTRRA enactment, IRC §4980F requires more detailed notices of Plan terminations or future benefit accrual reductions than under prior law. IRS proposed regulations have been issued explaining notice requirements with "good faith" compliance being required until regulations are final.

3. Comment - Plans with under 100 participants, or that give a choice between the new formula and the old formula, can be allowed (by IRS) to use a simplified notice form.

Horror - 2001 Act imposes $100 per day penalty for failure to provide notice to any applicable individual.

Example - Notice non compliance period is 30 days and 20 people involved. $60,000 penalty! Not to worry! The law limits the excise tax to $500,000 per year if the employer exercised "reasonable diligence." An "egregious failure" to comply with any notice requirement invalidates the benefit cutback for all!

4. Proposed Regulations were issued April 23, 2002 (Reg §§1.411(d) - 6 and 54.4980F-1). Reading them is a must whenever considering reduction of benefits (or [under new EGTRRA] elimination or reduction of an early retirement benefit or retirement type subsidiary) in a Defined Benefit, Money Purchase or Target Benefit Plan, i.e. plans subject to IRC §412 minimum funding requirements).

Highlights:

- Small plans with under 100 participants continue to have a 15-day advance notice standard.
- Plans with 100+ participants have an increased advance notice period – "45" days instead of the former "15."
- Exception – A "15"-day rule continues to apply to amendments adopted in connection with an acquisition or disposition.
- Q&A 11 describes the information required to be provided in a Section 204(h) notice. The type and amount of information varies depending on the nature of the amendment (see examples in proposed regs). The regs require use of one or more examples in the notice if it is not reasonable to expect the magnitude of the reduction to be apparent to participants from the description of the change.

5. Q&A 14 describes the penalties for failure to provide a notice, or failure to provide an adequate notice, i.e., disregard of the amendment, and excise taxes under IRC §4980F.

Safe Harbor Tax Explanation for Distributions.

- IRC § 401(f) requires a written notice from a Plan Administrator to a recipient (posting the notice is insufficient) of an eligible rollover distribution within a reasonable time before the distribution). An EGTRRA compliant safe harbor notice was issued by the IRS in Notice 2002-3. Previous safe harbor notices are no longer compliant – due to significant changes in rollover rules under EGTRRA.

Reg §1.402(f)-1 Q&A 5 explains that the notice may be provided in electronic form (e.g., e-mail) as long as the participant is advised he/she may receive a written paper copy at no charge. The e-mail site must be accessible post-employment (TD No.8873, 2/8/2000).

Penalties. IRC § 6652(i) imposes a $100 penalty per failure to distribute the notice (on notice and demand from the Secretary of the Treasury). Civil liability to a participant is also conceivable – assuming he/she claims he/she "messed up" tax-wise due to failure to receive a notice.

Post 2002 COLA Increases

The following limits do not change for 2003:

1.	Defined Benefit Annual Benefit Limit	$160,000
2.	Defined Contribution Limit	$40,000
3.	Compensation Limit	$200,000
4.	Key Employee Compensation	$130,000
5.	Highly Compensated Employee	$90,000

The following limits went up with COLA:

ESOP dollar amount for 5 year distribution period: $800,000 to $810,000

Statutory Increases are:

401(k)/403(b) deferrals	$11,000 to $12,000
Post-50+ catch-up	$1,000 to $2,000
Simple IRA deferral	$7,000 to $8,000

Stay Tuned

The House Ways and Means Committee have approved the "Retirement Savings and Security Act." This bill might pass in early 2003, perhaps late 2002, to accelerate scheduled increases in 401(k) and IRA deferral limits - and raise the required age for distribution to 75.

Sarbanes-Oxley Blackout Periods.

The Sarbanes-Oxley Act of 2002 amended ERISA Section 101(i) to require administrators of Defined Contribution Plans to give notice of any blackout period to all participants and beneficiaries. ERISA Section 101(i)(2)(B) requires at least a 30-day (but less than 60 days) advance written notice (in advance of the last day direction can be given) to all affected participants and beneficiaries.

The new law is a reaction to Enron's widely publicized troubles. One ignores the new rules at grave peril. The regulations describe rules for the content of the notice. There are exceptions in connection with certain company mergers, sales or purchases.

The rules apply to any blackout period beginning after January 25, 2003. ERISA § 502 creates a civil penalty for noncompliance of up to $100 per day per participant. That is in addition to civil liability to participants who claim harm due to a violation.

Comment: Why wait? The "community standard" is set- so you are well advised to follow the new rules for any blackout period beginning from today until January 26, 2003.

IRS/DOL Joint 5500 Project.

EFAST, IRS and PWBA are now (supposedly) fully integrated and can detect late 5500 filers. The IRS and DOL may have figured out how to use all that computer equipment they have acquired. And they are using it to catch late 5500 filers. The U.S. Department of Labor's Pension and Welfare Benefits Administration (PWBA) and Internal Revenue Service announced on October 7, 2002, a joint project to ensure that all employee benefit plans have complied with their annual return/report (Form 5500) filing obligations under the Employer Retirement Income Security Act (ERISA) and the Internal Revenue Code. Failure to do so may result in significant monetary penalties. The IRS database regarding deductions for qualified plan contributions, the IRS database regarding determination letter applications, and the e-fast database regarding 5500 filings are all being forwarded to the IRS office in Ogden. What Ogden will be looking for is a deduction or a determination letter application for a plan that does not have a 5500 filing.

Corporate Owned Life Insurance IRS Position Upheld.

The Third Circuit Court of Appeals upheld the Internal Revenue Service's victory in IRS v. CM Holdings, Inc. 86 AFTR 2d 2002-6470 (254 B.R. 578), aff'd __ F.3d.__ (3d. Cir. 2002). The court found that a pre-1996 "broad based" life insurance program was an economic sham. The amount deducted as life insurance policy- based interest (almost $14 million over 4 taxable years) was disallowed and penalties for "substantial understatement" of income were upheld. The Third Circuit's decision, when considered together with the government victories in Winn Dixie Stores, Inc. v. Comr., 254 F.3d 1313 (11th Cir. 2001), cert. den. (2002), and American Electric Power, Inc. v. U.S., 136 F. Supp.2d 262 (S.D. Ohio 2001) indicates that the pre-1996 issues under review in these cases may be viewed as relatively settled.

In CM Holdings, the corporate taxpayer borrowed each of the first three annual premiums for policies on the lives of approximately 1,400 employees and "paid" annual premiums 4 through 7. Those premium payments were made with the assistance of (i) so-called "loading dividends" which, themselves, were funded from premiums that the dividends were assisting (and were structured, according to the court, to generate coverage for expenses well in excess of those reasonably to be anticipated), and (ii) partial distributions from the policies.

The IRS challenged the deduction for interest on these borrowings on the grounds that the loading dividends used to fund the premiums were shams in fact, and that the transactions as a whole lacked economic substance.

In 2002, the trial court concluded that, while the transactions during the first three years of the policy life were not "shams in fact," the transactions, as they related to years 4 through 7, were such shams because they were primarily funded with the loading dividends that were the product of a circular accounting treatment. Further, because those four premiums during years 4 through 7 were shams in fact, there was not the level premium structure during the 7-year measuring period required by the Section 264(c)(1) "4-out-of-7" test. Thus, the interest deductions during the first 3 years (not only the deductions during years 4 through 7) were disallowed.

The trial court also found that the transaction, taken in its entirety, lacked objective economic substance as well as a subjective business purpose other than tax benefits falling from the interest deductions. As a consequence, the taxpayer's plan was a "sham in substance," which characterization served as an additional basis for disallowing the interest deductions.

Pre-Age 59½ Liberalization (Maybe)!

Rev. Rule 2002-62 was issued October 3, 2002, to update Notice 89-25's rules on permissible pre-age 59½ penalty exceptions. The three basic methods of Notice 89-25 were preserved (quotient method, fixed amortization or fixed annuitization). Special rules were promulgated as follows:

A. 2002-62 specifies use of either the life expectancy tables in the ruling, or § 1.401(a)(9)-9 of Income Tax Regulations.

B. Interest Rate maximums are now specified (there was no specific guidance before) as 120% of the federal mid-term rate for either of the two months preceding the distribution commencement date.

C. Account balance for the determination is based on facts and circumstances. A (impermissible) modification to the payments will occur if additions or subtractions to the account occur as a result of anything other than gains or losses.

D. An impermissible modification will not occur if the account depletes to zero.

Example. Taxpayer, age 50, starts out with $200,000 IRA and takes a periodic payment under an acceptable method. His Enron Stock goes to zero and the account is worthless at age 55. There is no retroactive 10% penalty even though payments until 59½ are impossible.

E. One Time Change (huge). A taxpayer who used either the fixed amortization method or fixed annuitization method may switch once in a later year to another method - or recalculate the minimum - and the change is not a modification.

Example: Taxpayer, age 50, starts in 2000 with an IRA with $200,000 in high tech stock. Took a single life annuity distribution of $14,173 (using 7%). Account is now worth $50,000. He decides to switch methods in January 2003 using 120% of the November 2002 mid-term rate. 120% Midterm rate is 3.68%. The annual post-2002 payment drops to $2,278. This can be done only once.

Final Regulations for Post 70½ Payouts.

Final regulations were finally issued (18 years after the 1984 Tax Reform Act) on distributions after age 70½. NO huge surprises - as the regulations kept the basic structure of regulations proposed in 2001 - with the following comments:

A. New longer life expectancy tables were issued (see Publication 590 Supp).

B. Designation of beneficiary "snapshot" date (or to provide documentation for a trust beneficiary) is moved up from December 31st of year following year of death to September 30th of that year.

Comment. Regs make clear that the "elimination" period is only to allow early payoff of a designated beneficiary, not to allow a post-death switch of a beneficiary for reasons other than a disclaimer.

C. There are some very technical changes in the "default rule."

D. Marital status is determined as of January 1.

E. The IRS issued model amendments for plans to use to update the final regulations.

Treasury Decision 8987 provides that taxpayers may rely for 2002 on the new regs, the 2001 proposed regs or the 1987 proposed regs. The final regs apply after 2002.

Split Dollar Insurance Update. Notice 2002-8 (1-3-2002)

IRS issued the second major overhaul of rules for Split Dollar Insurance Benefit Plans in 35 years! Notice 2002-8 revoked and superceded Notice 2001-10.

What is split dollar insurance? Two basic types:

1. Old Traditional: Corporation (usually "C" corporation with available 15% federally taxed earnings) "advances" funds to a key executive or owner to assist him/her to purchase insurance. Employee is taxed on P.S.58 (see Notice 2002-59 for post-1-27-2002 arrangements- Table 2001 applies to compensatory arrangements i.e., between employer and employee after 1-27-2002) economic cost of death benefit, or, if less, the insurer's lowest published available term rate.

Example - Premium $20,000 per year. Corporation advances $19,000 to employee (nondeductible), with $1,000 also advanced to pay the lowest published "term cost" of $1,000 (the $1,000 is deductible to corporation and taxable to employee). Employee then accrues a $19,000 liability to corporation - payable upon termination of employment or death - but the liability is "interest free."

2. New Traditional: Same as above except "advance" is not "interest-free." Choice between: (a) interest bearing loan (rate depends on loan terms- a demand loan is advised to avert income attributable to the entire term of the loan unless the interest rate is sufficient to avert imputed income under the regulations. See Prop. Reg 1.7872-15).

Examples

1. Old Traditional: Assume corporation "loans" $19,000 per year for 10 years and the low load insurance policy cash value increases by 8% per year. Assume at the end of 10 years cash value is $275,244. The employee "owes" $190,000. Thus, $85,244 has been transferred potentially "tax free" to the employee. The employee's heirs would get this amount income tax free if he/she died (estate tax is still an issue).

2. New Traditional: Same facts. The employee either accrues interest on the $190,000 (assume 3.5% average due to a demand feature) (with imputed interest consequences to corporation - and investment income limitations on the employee) or he/she will owe tax (after the Regs are final) on the $85,244 cash value increase in the years it accrued.

Comment - The $85,244 "secret" transfer of funds from the corporation to the employee is no longer permissible - tax free.

Comment 2: Hardly anyone used P.S.58 tables for Traditional Split Dollar (in favor of the "lowest published term cost"), so the principal impact of Notice 2002-8 on TSD is the canceling of interest free loans.

Limited Grandfathering of pre-1-28-02 Contracts. The IRS will not tax the employee, in most arrangements, on the cash value increase for pre-1-28-02 until the transaction is terminated. The split-dollar contract will not be treated as terminated until the economic benefit reporting stops, regardless of how small the employer's interest becomes. Notice 2002-8 indicates that on termination of the arrangement, the employee would be taxed on the value of the policy transferred or released to the employee. Arrangements which were not previously treated as loans may be treated as loans beginning in the year such loan treatment is adopted. For arrangements entered into prior to January 28, 2002, no tax will result on termination of the arrangement if the arrangement is terminated prior to January 1, 2004, or all employer contributions (principal without earnings) are treated as loans on or before January 1, 2004, and thereafter the arrangement is treated as a loan.

3. Old Reverse Split Dollar: Corporation owned by one family desires to purchase insurance protection for the corporation. Owner purchases life insurance policy on his/her life (or second-to-die coverage). Reverse Split Dollar Contract adopted for owner to "rent" his/her death benefit to the corporation for 20 years. Corporation then agrees to pay premiums for a specified number of years equal to the "P.S.58" cost of the insurance. Often the 20 years of P.S.58 was aggregated and bunched up in the first 5-7 years. The corporation usually (in my cases - but some more adventuresome practitioners do not do this) gets a 4% - 5% discount for advance P.S.58 payments.

Comment – P.S.58 Table was based on 1946 mortality – way overstated for modern life! Thus, RSD's net effect was for the corporation to use an IRS table to overpay for death benefit protection. The corporation's premiums were nondeductible but normally used 15% rates. The excess overpayment was an "indirect" low taxed "transfer" to the owner. Once the corporation paid the present value of 20 years of P.S.58, any other premiums had to be paid by the owner individually – possibly with assistance of Traditional Split Dollar.

4. New Reverse Split Dollar: Same as above but Notice 2002-59 economic benefit analysis must be used! Thus, benefit of RSD is much reduced.

Caution – Notice 2002-59 stated "**taxpayers may not use the P.S.58 rates for "reverse" split dollar arrangements."**

Example:

Insurance Factor (per $1,000 of coverage)	P.S.58	Table 2001*
Age 65	$31.51	$11.90

*Table 2001 is not necessarily the proper rate under 2002-59

Use of P.S.58 under RSD results in a $19.61 per thousand dollars of coverage overpayment (subsidy to the employee).

Comment – RSD is far less effective under Notice 2002-59.

Future Split Dollar Arrangements must either be set up as (a) loans, or (b) (if the Split Dollar Arrangement does not give the corporation repayment of the "loan" with interest or a way to secure its advance), compensation of the entire amount to the employee.

Added Comment –The new proposed regulations and Notice 2002-59 also claim these principles apply to arrangements with shareholders, non-employees and "arrangements involving gifts" (i.e., private split dollar with children or an Irrevocable Trust to fund life insurance).

Consider Before 2004: For pre-January 28, 2002 split-dollar arrangements with high cash values, consider termination of the arrangement before January 1, 2004, to avoid the tax on equity build-up forever. For pre-January 28, 2002 split-dollar arrangements with low cash values, where the premium offset year has passed or will soon pass (i.e., when the policy becomes self-sustaining), switching to loan treatment may be preferable. A split-dollar arrangement should be structured so that it will be taxed under as a loan (Prop Reg § 1.7872-15) if:

- the transaction is entered into after the proposed regs are finalized (and thus is subject to those rules),
- cash value will build up in the policy, and interest rates remain low.

Refresher In Basic Concepts of EGTRRA

I. Introduction

EGTRRA revolutionizes ERISA and the options for Qualified Plans and their interaction with IRAs. This Refresher Section will try to point out important provisions of ANEW-ERISA@ that affect your practices after 2001.

II. Review of Qualified Plan Choices

A chart showing basic types of Qualified Plans allowed under IRC ' 401(a) follows:

TAX QUALIFIED PLANS BY CATEGORY		
Qualified Plans		Individual Retirement Accounts
Defined Contribution	Defined Benefit	
- Profit Sharing Plans - 401(k) Plans - Money Purchase Plans - Target Benefit Plans - Thrift Plans - Age Weighted (or Rate Group) Cross Tested Profit Sharing or Money Purchase Pension Plans - Employee Stock Ownership Plans (ESOPs) - Stock Bonus Plans	- Fixed Benefit with numerous benefit formula options vs. - Cash Balance	Simplified Employee Plans (SEP) -Salary Reduction SEP (no new ones after 1996) - Individual Retirement Accounts - SIMPLE (After 1996)

Brief overview of features of each type:

1. Profit Sharing Plan

OLD-ERISA - Discretionary contribution. 0-15% of salary (subject to $170,000 annual salary cap). Requires periodic contributions for qualification unless

contributions formally discontinued. PSP can allow Asecond-to-die@ life insurance and allow premiums to exceed 50% of contributions (25% for universal or variable life) if contributions Aseason@ over 2 years.

NEW-ERISA - Discretionary Contribution - 0-25% of salary (subject to $200,000 annual cap). (IRC ' 404(a)(3)(A)(i)(I).)

Comment - A revolutionary change! A Profit Sharing Plan can now do it allBwith no need for a 10% Money Purchase PlanB15% Profit Sharing Plan to get to 25%. Are Money Purchase Plans dead? See below.

2. Money Purchase Pension Plan

OLD-ERISA - Fixed contribution percentage (percentage of salary). Plan amendment needed for a change (more than 15 days prior to end of Plan YearBmore (more than 15 days prior to accruing benefit) if no year end employment requirement). Can (as can a PSP) be integrated with Social Security to give slightly more to higher compensated. 0-25% of salary range permitted for formula.

NEW-ERISA - Same as before but PSP 0-25% range renders moot for most circumstances. Are MPPs dead? Answer - No but they are on life support!

Comment - Terminating a MPP after 2001 to Aboil down@ to 1 Plan could trigger 100% vesting in the MPP. Suggestion - Merge MPP with PSP (assuming all documentation is done correctly - qualified joint and survivor options must be preserved for MPP funds) - and amend the PSP to provide a mandatory fixed contribution percentage designed to prevent 100% vesting. This could allow continuing with one Plan, without accelerating vesting.

Comment - MPPs are still valuable where a fixed contribution of a small percentage is desired (as the qualification of a PSP with a 1% annual contribution might be questioned) or where a Azero percent contribution@ is desired. IRS regulations arguably prohibit PSPs that never make, or never have made contributions. IRS announcements and news publications do allow a zero percent Money Purchase Plan.

Example - Doctor Jones terminates his corporate Defined Benefit Pension Plan with a $1,000,000 benefit. He desires no further contributions to any Qualified Plans, but also desires the extra flexibility to be his own trustee, and the added creditor protection of a corporate Qualified Plan. Solution? Create a zero percent Money Purchase Plan for the rollover/direct transfer of his DB benefit. He could also be the only participant in it even if he has other employees who meet statutory eligibility requirements. Benefit of that? Doctor Jones can invest Plan funds in Non-Qualified Assets without generating a bonding/CPA audit requirement (A later discussion of those rules is reserved for an Advanced Session).

Comment - OLD-ERISA - Often a 10% MPP is combined with a 0-15% PSP to allow a 10-25% range.

NEW-ERISA - New PSP-MPP combos are obsolete! Per above discussion, advisors and Plan Sponsors need to decide what to do with pre-2002 PSP-MPP combos.

3. 401(k) Plan

OLD-ERISA - PSP variation allowing employee deferral. If elected by Employer, matching contributions by Employer. $10,500 annual deferral limit (subject to COLA). 25% of salary limit applies to limit deferrals (Liberalization in 1998 includes deferrals for the 25% calculation). Average Deferral Percentage/Average Contribution Percentage Tests under IRC ' 401(a) limit how much Highly Compensated Employees (IRC ' 414(q)) can contribute in relation to others. Post 1998 ASafe Harbors@ can eliminate ADP/ACP testing if the Employer makes specified minimum contributions.

Comment - Allows individual employee flexibility. Need not be employer funded except to extent needed for top heavy rules of IRC ' 416 (if Akey@ employees contributed).

NEW-ERISA - Incremental and Revolutionary Changes as follows:

1. Deferral Limits go up each year as follows (ADP Testing Still Applies unless a safe harbor election is in place)

2002	$11,000
2003	$12,000
2004	$13,000
2005	$14,000
2006	$15,000

2. Catch Up for 50+ (IRC ' 414(v)) ADP Testing Does Not Apply

2002	$1,000*	(* Simple 401(k) Plan limits are 50%)
2003	$2,000	
2004	$3,000	
2005	$4,000	
2006	$5,000	

Note - ACatch-up@ also applies to 403(b), 457 Plans and SIMPLE IRA (50% of 401(k) limits for SIMPLE IRA). The Acatch-up@ does not apply during the final 3years before retirement age in a 457 Plan due to the doubling of the 457 Plan limit in those years.

Note - Age 50+ is measured as of the last day of the tax year. Catch-ups do not count against the $40,000 Defined Contribution Plan limit! Proposed Reg. 1.414(v)-1 also allows a plan to reclassify an HCE=s Aexcess deferral@ (amount flunking ADP test) as a catch-up contribution. A catch-up cannot be used until the Participant has used all other available elective deferrals. Some advisors are considering a separate 401(k) Plan that only allows catch-up contributions. Why? This will allow HCEs to make contributions to the Acatch-up 401(k)@ first and thereby reduce the HCE ADP % in a separate non-safe harbor 401(k) Plan. (The Proposed Reg. reduces the need for a separate 401(k) catch-up plan by allowing reclassification, but a separate catch-up Plan may be useful where an employer does not want the hassle of a broad based 401(k) plan).

Announcement 2001-93 advised employers to report elective catch-up contributions in the W-2 Box 12 using Codes D through H and S.

3. 100% Salary Limit for Deferrals. ADP testing still applies.

Example - $11,000 salary. Contribution of 100% of salary to a 401(k) is allowed! (subject to ADP testing).

Caution - Salary actually needs to be slightly larger than $11,000 to allow a source for the employee=s FICA and state disability payroll taxes!

4. Deduction Limit Expansion!

A. Compensation for deduction limit includes 401(k) deferrals, Cafeteria Plan deferrals and Section 457 Plan deferrals!

B. IRC ' 404(n) will provide that 401(k) elective deferrals are not subject to the 25% of salary deduction limit.

C. Faster Vesting for Matching Contributions. (This really affects only non ATop Heavy@ Plans):

	OLD-ERISA MAXIMUMS		NEW-ERISA MAXIMUMS	
Vesting Years of Service	1	2	1	2
1	0	0	0	0
2	0	0	0	20%
3	0	20%	100%	40%
4	0	40%	100%	60%
5	100%	60%	100%	80%
6	100%	80%	100%	100%
7	100%	100%	100%	100%

Effective Date: For contributions for Plan Years beginning after 2001.

D. Multiple Use Test (ADP/ACP interaction) Eliminated after 2001!

E. Suspension of Deferrals Period Reduced.

Congress directed the IRS to revise hardship withdrawal regulations to reduce the required suspension period against new deferrals after a hardship withdrawal to 6 months (from 12 months). This applies to years after 2001, but does not require a reduction to 6 months for hardship withdrawals made prior to 2002.

Example 1 - One Person/Family 401(k) Plan

OLD-ERISA

Husband - Wife (both age 50) No Employees - H makes $100,000. W makes $20,000
401(k) Plan (usually would not have made sense prior to 2002)

Business contributes $18,000 (15% of salary) with no 401(k) deferrals needed or possible given deduction limits.

NEW-ERISA

Same facts: Employer contributions are $54,000! How?

Husband: $11,000 Deferral
1,000 Post 50 catch up
$25,000 PSP contribution
$37,000* *40,000, plus the catch-up of $1,000, is the dollar limit even if H=s salary is higher than $116,000

Wife: $11,000 Deferral
1,000 Post 50 catch up
$ 5,000 PSP contribution
$17,000

Grand Total: $54,000!

$54,000 vs. $18,000! Truly revolutionary!

Example 2 - Company Has Employees

Assume Company adopts Asafe harbor@ 401(k) Plan with a mandatory 3% of compensation contribution for eligible personnel (see IRC ' 401(k)(12) for 401(k) safe harbor rules). Also assume average age of employees is 25 - thereby allowing a generous Across-testing@ formula for owners.

Note - ASafe harbor@ requires 100% vesting of the qualifying contributions.

OLD-ERISA

	Compensation	Cross Tested Company Contribution	Deferrals*
Husband	$100,000	$19,208	$0
Wife	20,000	3,842	0
Employee 1	40,000	1,200	5,000
Employee 2	30,000	900	0
Employee 3	20,000	600	0
	$210,000 ($205,000 is the amount to multiply by 15% - $5,000 401k deferral)	$25,750 (15% of compensation minus the $5,000 401(k) deferral)	*Deduction limits restrict deferrals of H & W

Note - Cross Testing Rules change after 2001.

NEW-ERISA

	Compensation	Cross Tested Company Contribution	Deferrals
Husband	$100,000	$29,000	$12,000
Wife	20,000	9,000	12,000
Employee 1	40,000	2,000*	5,000
Employee 2	30,000	1,500*	0
Employee 3	20,000	1,000*	0
	$210,000	$42,500	$29,000

Note - *(5% instead of 3%) Cross Testing Rules minimum contribution rules change after 2001.

Note - Maximum contribution for Husband is $41,000 per IRC ' 415(c)
Maximum contribution for Wife is $21,000 per IRC ' 415(c)

Old ERISA Contribution for H-W is $23,050 (at employee cost of $2,700)
New ERISA Contribution for H-W is $62,000 (at employee cost of $4,500)

Example 3 - Company has employees - No age leverage - Social Security Integration Used

Assume same Asafe harbor@ 401(k) with Social Security integration.

OLD-ERISA - (Assumes $84,900 2002 Taxable Wage Base)

	Compensation	Company Contribution	Deferrals
Husband	$100,000	$3,453	$10,500
Wife	20,000	600	4,400** **5,000 is 415 limit
Employee 1	40,000	1,200	5,000
Employee 2	30,000	900	0
Employee 3	20,000	600	0
	$210,000	$6,753	$19,900

NEW-ERISA

	Compensation	Company Contribution	Deferrals
Husband	$100,000	$3,453	$12,000
Wife	20,000	600	12,000
Employee 1	40,000	1,200	5,000
Employee 2	30,000	900	0
Employee 3	20,000	600	0
	$210,000	$6,753	$29,000

Old ERISA Contributions for H-W = $18,953 (at employee cost of $2,700)

New ERISA Contributions for H-W = $28,053 (at employee cost of $2,700)

Note - In 2006 the situation could look like this:

	Compensation	Company Contribution	Deferrals
Husband	$100,000	$3,000*	$20,000
Wife	25,000	600	20,000
Employee 1	40,000	1,200	5,000
Employee 2	30,000	900	0
Employee 3	20,000	600	0

*Assumes SS Wage Base exceeds $100,000

Total H-W contributions = $43,600 (at total employee cost of $2,700)

4. Target Benefit Plans

A Money Purchase/Defined Benefit hybrid. 25% of salary deduction limit applies, but formula is based on anticipated level of benefits (as a percentage of compensation or compensation based formula) at retirement age. Age weighted plan.

Comment - Ideal if older owners, younger employees and owner is satisfied with mandated contributions and 25% of salary deduction limit.

NEW-ERISA - The advent of Cross Tested PSPs with a 0-25% deduction limit will make most Target Benefit Plans obsolete!

5. Thrift Plans

Not common. A 401(k) type of plan in which employee contributions are after-tax. ACP test of IRC ' 401(m) applies.

6. Age Weighted/Cross Tested Plans

OLD-ERISA - A Profit Sharing Plan or Money Purchase Plan can use age weighted formulas or rate group cross tested formulas under IRC ' 401(a)(4) regulations. 25% limit applies.

Age Weighted - Each participant=s contribution varies based on salary and age.

Rate Group/Cross Test - Employees are grouped in nondiscriminatory (per Regs) classifications. Employees in same group get same contribution percentage.

Comment - Ideal for older owners and (on average) younger employees. Rate group can help eliminate age based disparities within groups.

NEW-ERISA - Profit Sharing Plans will be the norm for Rate Group/Age Weighted/Cross Tested Plans due to the 25% limit.

Regulations on Rate Group Comparability were issued in final form during 2001. These regulations specify, for Across-tested@ plans, a 5% floor, or, if less, a of the percentage amount allocated to HCEs as a floor for post 2001 Plan Years. The 25% of overall compensation deduction limitBcombined with the 100%/$40,000 limit on Defined Contribution PlansBcan provide interesting results. See example below (assume owner is 55 and average age of NHCEs is 25):

	Compensation	Contribution
Owner/HCE	$100,000	$39,000 (39% of pay) (limit under Old ERISA is $25,000)
Employee 1	40,000	2,000 (5%)
Employee 2	30,000	1,500 (5%)
		$42,500 (25% of pay)

Note - A 39% vs. 5% percentage spread is a dramatic example. Actuarial calculations are needed to demonstrate compliance with cross testing regulationsBand with smaller age spreads the percentage rate will narrow.

7. Employee Stock Ownership Plans (ESOP)

A Profit Sharing (can include a Money Purchase Plan) type of Plan in which over 50% of Plan assets are intended to be invested in employer stock. Special ESOP exemptions from IRC ' 4975 AProhibited Transaction@ rules allow employer or owner loans to an ESOP, or guarantees of such loans. ESOPs are also normally exempt from asset diversification rules (to the extent of employer stock).

Comment: Suitable for C corporations (and S corporations in certain instancesBNew law restricts use of new S corporation ESOPs and phases out old onesBsee ESOP discussion in Advanced Session) desiring to give employees indirect ownership of stock, or help finance shareholder buyouts with pre-tax (at least for the time being) dollars.

Pros - Include pre-tax contributions of funds to acquire corporate stock, potential tax deferred stock exchanges under IRC ' 1042 and potential employee motivation.

Cons - Include valuation costs, heightened fiduciary liability for loss in value, loss of flexibility in deal negotiations due to fiduciary obligations to ESOP, eventual repurchase liability to reacquire shares, potential that the Aowner(s) are financing their own buyout.

Comment - A discussion of Old ERISA vs. New ERISA will occur in the Advanced Session.

8. Defined Benefit

Different type of Plan family from Defined Contribution. Specifies a monthly benefit at retirement age and an actuary, under IRC ' 404 and ' 412 determines the annual contribution minimum and maximum.

Pros - No 25% of salary limit, if owners are old enough. Allows investment losses to be recovered through tax deductible contributions.

Cons - More costly to establish and administer. Minimum funding rules can mandate re-funding losses. Employee costs (e.g., top heavy minimums) can be more than other approaches. Pension Benefit Guaranty Corporation premium and coverage involvement in all but owner only (or small professional practice entities). Can become fully funded and then no contributions to the Defined Benefit may be possible. Contributions to a Defined Contribution Plan can then begin. Investment growth above assumed rate reduces contributions. Not ideal for multiple owners Asharing@ same plan.

Comment: Defined Benefit Plans normally work best as Atax shelter@ devices in small businesses without multiple owners and with older owners (late 40's or older) and younger employees.

OLD-ERISA - Defined Benefit Plans prior to New ERISA have the following limits:

1. Maximum Benefit $140,000 per year beginning at Social Security Retirement Age. Reduced for earlier NRA.

2. $170,000 maximum creditable compensation.

3. Contributions cannot exceed Afull funding limit.@

NEW-ERISA - Big changes in deduction limits.

1. Maximum Benefit $160,000 per year with no reduction for retirement ages of 62 or above - Effective for Plan Years ending in 2002 or later.

2. $200,000 maximum creditable compensation. Notice 2001-56 states the $200,000 amount need not be phased in over 3 years (i.e. assume

compensation of $200,000 in each of 2000, 2001 and 2002. The $170,000 limit need not apply to limit compensation in 2000 and 2001! The Aaverage 3 high years@ for 2002 therefore is $200,000!)

3. Deduction limit is the unfunded current liability limit.

Comment - For Plans with 100 or fewer participants, unfunded current liability does not include liability attributable to benefit increases for highly compensated employees resulting from Plan amendments made or effective within the last 2 years. IRC 404(a)(1)(D)(iii).

Examples

1. Initial maximum deduction amount for age 55 employee (earning over $200,000 per year and NRA of 62/5 years) under Old ERISA $96,900BNew ERISA $147,700.

2. Benefit formulas can be reduced by 17% or so and still produce same benefit for over $200,000 compensated employeesBpotentially reducing employee costs.

3. Assume DB Plan has $1,000,000 at beginning of 2002 and due to investment losses has $600,000 on December 31, 2002. Assume current benefit liability is $1,100,000. Deduction for 2002 can be $500,000 (or so)!

4. Consider a DB combined with a "deferral only" 401(k) for maximum deductions.

Comment - Concerned about sunset of new rules on December 31, 2010 on ability to use higher limits? Rev. Rul. 2001-51 is the official IRS position allowing us to ignore the sunset for benefits accruing prior to Plan Years beginning after 2010.

9. SIMPLE

Form 5304/5305-SIMPLE incorporates the SIMPLE/IRA plan. The SIMPLE/IRA (simple/401(k) will be briefly touched on at the program) offers an option many employers of under 100 employees will desire.

SIMPLE/IRA allows deferrals per calendar year of $6,500 for 2001 and $7,000 for 2002. Post age 49 catch-up is 50% of 401(k) catch-up.

Pros: Deferral limit applies without regard to percentage of salary limit. Example - $7,000 salary in 2002 - $7,000 deferral contribution okay. No business fiduciary exposure after contribution. No IRS 5500 forms. No ADP/ACP top heavy testing (SIMPLE contributions are required).

Cons: Requires either 3% match (can go to 1% in 2 of 5 years) or 2% across board contribution. 25% penalty if withdrawn within 2 years of first contribution. Less creditor protection than qualified plan. No loans to participant. Calendar year requirement means deductions are not properly matched to fiscal year taxpayers. No other qualified plans can accrue or be funded in a year a SIMPLE plan is used.

10. SEPS (IRC ' 408)

IRA arrangement similar to Profit Sharing Plan.

OLD-ERISA - 15% deduction limit (13.043% for sole proprietor, self-employed).

NEW-ERISA - 25% deduction limit, 20% for self-employed. Can be integrated with Social Security with proper Adoption Agreement. Can be set up on a fiscal year with proper Adoption Agreement.

Pros: Contribution flexibility. Employee withdrawal flexibility (subject to tax penalties). No IRS 5500 forms. No fiduciary exposure after contribution. Can allow channeling Abonuses@ through SEP (based on percentage of pay) to allow owner(s) to Apiggyback@ on SEP/bonus. 3-year eligibility (comparable to 2-year eligibility in qualified plan as to how it works).

Cons: Has IRA features vs. qualified plan features. Cannot use Ayear end employment@ feature (even if IRC ' 410(b) coverage test met) or 1,000 hours per year minimum for eligibility. No exclusion of categories of employees even if 410(b) can be met.

Example - Assume $250,000 sole proprietorship net income - No employees

OLD-ERISA - SEP contribution $25,500

NEW-ERISA - SEP contribution $40,000

11. SAR-SEP (IRC ' 408, pre-1997)

Prior ASIMPLE@ type arrangement. No new ones after 1996 per Small Business Act of 1996.

Pros: Similar benefits to SIMPLE, but salary percentage limits apply. $10,500 2001 and $11,000 2002 deferral limit, subject to ADP test (using 125% portion of test and HCEs not averaged) and top heavy test. No employer required contributions (except top heavy if key employees contribute) and no match allowed.

Cons: Same as SEPs. Limited to companies with 25 or less eligible employees. No matching contributions (this is both a pro and con).

III. OTHER QUALIFIED PLAN BASIC ISSUES

1. U.S. Pays You to Set Up Plan!

OLD-ERISA - No tax credits for new Plan set-up.

NEW-ERISA - Revolutionary! $500 maximum credit for each of first 3 years of small employer=s start up costs, administration expenses and retirement education (definition same as for SIMPLE IRA eligibility) for a new plan. IRC ' 45E. Must be a new Plan**B**and cannot supplement an existing plan (i.e. employer cannot have maintained a plan with contributions during 1999, 2000 or 2001). At least one non-highly compensated employee must be eligible.

Comment - No deduction is allowed for the amount equal to the start up cost credit.

Also, User fee for favorable determination letter request waived after 2001 for the first 5 years of a Plan=s existence for small employers (less than 100 employees who received $5,000 plus at least one non-HCE).

2. Top Heavy Rules Liberalized!

Top heavy plans (over 60% of benefits for Akey employees@) have new rules. IRC ' 416.

OLD-ERISA - AKey employee@ (with a 4-year look back) was:

A. Officers receiving $70,000+ (there were limits on the number of officers).

B. Top 10 owners who made over $35,000.

C. 5% owner.

D. 1% owner making over $150,000.

E. 401(k) matching contributions do not count toward top heavy minimums.

F. Distributions in 4-year look back period count in calculations.

G. Frozen Atop heavy@ Defined Benefit Plans still accrue top heavy minimum benefits for non key employees.

NEW-ERISA -

A. Four-year look back rule scrapped!

B. AOfficer@ status requires $130,000+!

C. Top 10 shareholder category scrapped!

D. AMatching contributions@ in a 401(k) Plan count toward top heavy contributions.

E. Only distributions in year ending on Adetermination date@ count in calcs (except for Ain-service withdrawals@ which still count for 5 years).

F. ASafe harbor@ 401(k) Plans (either nonelective or matching), with matching contributions meeting IRC ' 401(m)(11) safe harbors, will not be considered Atop heavy.@ IRC ' 416(g)(4)(H).

G. Frozen Defined Benefit Plans no longer will require top heavy minimum benefits for non key employees. HUGE CHANGE!

3. Governmental Employers and Tax Exempt Entities Section 457 Liberalization

OLD-ERISA - Maximum deferral to ' 457 Plan is $8,500, and the $8,500 applied against 401(k) Plans, SIMPLE IRAs, etc.

NEW-ERISA - ' 457 Plan deferral is the same as a 401(k) Plan base limit ($11,000 in 2002). The percentage of salary limit is 100%! Plus, this does not count against the 401(k)/SIMPLE IRA limits.

Example - Sally (age 50+) works part-time for the City of Oceanside and part-time for Qualcomm:

OLD-ERISA - Maximum contributions

457 Plan	$ 8,500
Qualcomm 401(k)	$ 2,000
	$10,500

NEW-ERISA - Maximum contributions

457 Plan	$11,000
Qualcomm 401(k)	$11,000 plus
	$ 1,000 catch-up
	$23,000

Other 457 Plan Changes:

1. AQualified Domestic Relations Orders@ rules apply to 457 Plans. This removes uncertainty at government and participant levels about whether post 2001 payments to ex-spouses under QDROs transfers the tax liability to the ex.

2. See ANew Portability@ discussion for new rollover options.

4. Represent Clergy?

Self-employed clergy exempt from self-employment tax can post 2001 qualify for Keogh and SIMPLE IRA plans. IRC '' 401(c)(2)(A) and 408(p)(6)(A)(ii).

5. Deemed IRAs IRC ' 408(q)

A qualified plan can, after 2002, set up a Adeemed IRA@ arrangement. This can allow an alternate method of funding an IRA.

Comment - Most employers will not want to deal with the extra administrative paperwork, but the opportunity for individual trusteeship of IRA funds could be attractive to some smaller employers. The ANew Portability@ options for IRAs allow an IRA rollover to a Qualified Plan anyway.

6. Post 2005 401(k) and 403(b) 401(k)/403(b) Roth IRA Type Contributions.

NEW-ERISA - ARoth type@ contributions can be made to 401(k) Plans or 403(b) Plans after 2005. Discussion on this point is premature but exciting opportunities would exist after 2005 for Roth after tax deferrals to a 401(k) Plan.

Comment - This will, after 2005, allow Roth type contributions of $15,000 per year to qualified plans (in addition to the regular Roth IRA contribution) without regard to income phase-out rules! Stay tuned.

7. Tax Credits for 401(k) Type Contributions!

IRC '' 25B, 26(a)(1), 904(h) and 1400C(d)

Congress pays the employer to set up the Plan!Band gives credits to participants who make 401(k)/SIMPLE IRA/457 Plan/Roth IRA/Traditional IRA deferrals. The credit is reduced by distributions (so as to reduce abuse of temporary contribution to get the credit).

Comment - The maximum credit that can be claimed on a joint return with AGI of $30,000 or less is $2,000 if both spouses each contribute $2,000 to a 401(k) type Plan.

8. Plan Loans to Sole Proprietors, Partners, LLC Members and S Corp Owners Exempt From Prohibited Transaction Rules After 2001. IRC ' 4975(f)(6)(B).

OLD-ERISA - Loans to partners owning over 10% of a partnership/LLC or 50% of an S corporation have been Aprohibited transactions@ since ERISA=s enactment.

NEW-ERISA - Loans to the formerly Aprohibited group@ are no longer singled out for special restrictions.

9. Involuntary Automatic Rollovers. IRC ' 401(a)(31)(B)

A qualified plan must provide involuntary cash-outs of between $1,000-5,000 are transferred to an IRA unless the participant elects otherwise.

Comments - These rules are effective for distributions after final DOL regulations are issued (expected 1-3 years from now). Query? What IRA custodians are going to accept these funds when the employer is setting up the account for him/her?

10. No Rollovers of Hardship Withdrawals

OLD-ERISA - Rollovers of 401(k)/403(b) plan hardship withdrawals were prohibited.

NEW-ERISA - Rollovers of hardship withdrawals of any type from matching contributions, employer contributions, etc. are not allowed.

Comments - Hardship withdrawals are not allowed from Money Purchase or Defined Benefit Plans. The new rule after 12-31-01 eliminates required withholding for post 2001 hardship withdrawals.

11. Draconian Notice Requirements. IRC ' 4980F.

Congress took offense to Acash balance@ conversions of Defined Benefit Plans (a Acash balance plan@ is a defined benefit plan that tends to reduce future accruals of older participants when compared to Atraditional@ Defined Benefit Plans).

For Plan amendments taking effect after enactment, IRC ' 4980F requires more detailed notices of Plan terminations or future benefit accrual reductions than under current law. IRS regulations were issued in early 2002 explaining notice requirements.

Comment - Plans with under 100 participants, or that give a choice between the new formula and the old formula, can be allowed (by IRS) to use a simplified notice form.

Horror - 2001 Act imposes $100 per day penalty for failure to provide notice to any applicable individual.

Example - Notice non compliance period is 30 days and 20 people involved. $60,000 penalty! Not to worry! The law limits the excise tax to $500,000 per year if the employer exercised Areasonable diligence.@ An Aegregious failure@ to comply with any notice requirement invalidates the benefit cutback for all!

IV. NEW PORTABILITY

1. EGTRRA revolutionized pension IRA portability to the extent that Aold timers@ like me need to learn it all over again! A bullet-point discussion follows:

2. After Tax Contributions to a Qualified Plan May Be Rolled Over to a Defined Contribution Plan or IRA After 2001. IRC '' 402(c)(2) and 401(a)(31)(B).

OLD-Portability - After tax contributions cannot be rolled over.

NEW-Portability - They can be rolled over to an IRA or DC Plan that maintains separate accounting for the after tax amounts.

Note - After-tax contributions still may not be rolled over to a 403(b) annuity or 457 Plan.

3. IRA Rollovers to Qualified Plans. IRC ' 408(d)(3)(A).

OLD-Portability - IRA funds, SEPs, etc. could not be rolled into qualified plans unless the IRA was a Aconduit rollover@ IRA consisting of only qualified plan rollover money.

NEW-Portability - IRA accounts can be rolled over to Qualified Plans, 403(b) Plans and 457 Plans. After-tax contributions and non-deductible contributions to an IRA (see #2 above for differing treatment of after-tax contributions to a qualified plan) cannot be rolled to a qualified plan.

Comment 1 - Only a Aconduit IRA@ can preserve capital gains or 10-year averaging treatment of qualified plan funds transferred from a QP to IRA to QP.

Comment 2 - The new rollover option allows a Ashakeout@ of after-tax funds.

Example - $100,000 in IRAs with $10,000 nondeductible basis. Old Portability says 90% of any distribution is taxable. New Portability allows rollover of $90,000 to QP, leaving $10,000 basis. Then withdraw $10,000 from the IRAB no tax!

Comment 3 - Rollover to QP can then allow IRA funds to be available for a participant loan from a ARollover Account.@

Comment 4 - Creditor protection will in many instances be better in a QPBcausing a post 2001 Afright flight@ of IRA funds into QPs.

Comment 5 - A rollover of IRA funds to a QP would subject the funds to greater restrictions on a spouse being the required beneficiary, or requiring spousal consent to distributions. Be cautious if the IRA funds are separate property! You could be increasing your spouse=s rights, especially if you die!

Comment 6 - Rollover from IRA to QP can also occur during a divorce to get IRA funds eligible for pre-age 59**2** distribution to participant=s ex-spouse under a QDRO without penalty!

4. Taxation of Traditional IRA Distributions Rolled to Non-IRA. IRC ' 408(d)(3)(H).

OLD-Portability - All traditional IRAs treated as one contract. ABlender@ applies to return of basis (no first in first out).

NEW-Portability - Distributions rolled to a non-IRA are treated as income on contract (to the extent of income from all IRAs). Each IRA is treated separately for basis calculations on a distribution made all, or in part, to a non-IRA Plan.

Example - H has two IRAs:

IRA 1. $10,000 of which $5,000 is basis.
IRA 2. $20,000 none of which is post tax.

H rolls over IRA #1 to a qualified plan. Now IRA #2 has $5,000 of basis!

Example 2 - H has the same two IRAs. Rolls over $5,000 of IRA #1 to a QP. The remaining $5,000 can be distributed to H tax free! The rollover of $5,000 to a QP allows IRA #1 to be considered separately from IRA #2. The Ablender@ is discarded!

5. Surviving Spouse Rollover. IRC ' 402(c)(9).

OLD-Portability - Participant dies with $ in QP. Spouse can roll over only to an IRA.

NEW-Portability - Spouse can roll over into a QP, 457 Plan, 403(b) Plan or an IRA.

6. 403(b) Plan Rollovers. IRC '' 403(b)(8)(A)(A)(ii) and 402(f)(2)(A).

OLD-Portability - 403(b) distributions can be rolled only to an IRA or 403(b).

NEW-Portability - Rollover is allowed to a QP, IRA, 457 Plan, 403(b) or IRA.

7. 403(b) Plans Accepting Rollovers. IRC '' 402(c)(8)(B)(vi).

OLD-Portability - Only 403(b)s could roll into a 403(b).

NEW-Portability - Rollovers from QPs, IRAs, and 457 Plans can also be rolled into a 403(b) (except after tax contributions to qualified plans).

8. 457 Plans Distribution and Rollover Options. IRC '' 457(e)(16), 457(b)(2).

OLD-Portability - 457 Plans had restrictive payout options (to avert Aconstructive receipt@) and no rollover to IRA option (only transfers to another 457 Plan were allowed). Special minimum distribution rules applied.

NEW-Portability - 457 Plans of Governments (tax exempts still have constructive receipt issues) no longer are subject to constructive receipt rules! Direct Rollovers of Government 457 Plan funds to IRAs are ok (unless the distribution is a hardship or ten year+ periodic payout)! The same post 70**2** rules as apply to QPs will apply to 457 Plans.

Comment - 457 Plans are not subject to pre-age 59**2** penalties. Rollover to IRA would invoke this issue for a pre-age 59**2** individual. Eliminating restrictive payout rules with an IRA rollover adds significant flexibility to government retirees. BIG RELIEF for affected people!

9. Rollovers to 457 Plans. IRC ' 402(c)(8)(B)(v).

OLD-Portability - Only 457 Plan funds were portable to a 457 Plan.

NEW-Portability - 457 Plans can allow rollovers from IRAs, QPs and 403(b) Plans (except for after-tax contributions originally made to qualified plans). Separate accounting is required for rollover funds to preserve the pre-age 59**2** penalty (Congress thought of everything! Loophole plugged!).

10. Same Desk Rule Eliminated. IRC '' 401(k)(2)(B), 401(k)(10), 403(b) and 457(d)(1).

OLD-Portability - Work for a Company today and a buyer tomorrow, but sit at the same desk? Depending on how the deal was structured old law may or may not have allowed a distribution from a 401(k), 403(b) or 457 Plan. These technical rules were a trap for the unwary**B**and some of the technical exceptions applied only if the buyer and seller were both corporations.

NEW-Portability - Severance of employment for an entity allows withdrawal of 401(k) funds even if you sit at the same desk!

Comment - Shift from LLC to corporation, sole proprietorship to corporation, shift from one Acontrolled group member@ to another member would not appear to qualify for the New Portability provision.

Comment - Terminating the services of a staff leasing company and shifting to another is a gray area needing IRS guidance. Arguably employment has not been severed as most staff leasing arrangements are really Ajoint employer@ arrangements, with Internal Revenue Code ' 414(n) deeming the Alessor@ of employees as the employer for benefit purposes.

11. Cash Out Rule. IRC '' 411(a)(11)(D) and 457(e)(9)(A).

OLD-Portability - Participant has $10,000 rollover account and $1,000 employer contributions account. He/she has over $5,000 and cannot be forced out of the Qualified Plan without consent (prior to age 62 or termination of the Plan).

NEW-Portability - Rollover Account is ignored. The above Participant with $11,000 can be involuntarily forced out of the Plan (presumably the default transfer mode will be an IRA once the DOL establishes regulations Bsee earlier discussion).

12. Anti-Cut-Back Rules. IRC ' 411(d)(6)(D).

OLD-Portability - Forms of benefits could not be easily eliminated when two or more Defined Contribution Plans merged.

NEW-Portability - Too technical to discuss, but new rules make it easier to eliminate unwanted benefit options when two defined contribution plans merge.

13. Notices. IRC ' 402(f)(1)(E).

These new portability rules get confusing don=t they? The existing Tax Explanation given to participants has to include an explanation of new rollover options.

Comment – The IRS issued a Asafe harbor notice.@

14. Hardship Exception to 60-Day Rollover. IRC '' 402(c)(3) and 408(d)(3)

OLD-Portability - Miss the 60-day rollover period for a reason. IRS had no authority to waive the 60-day period unless the participant was in military combat or the President declared a disaster and the disaster caused the delay.

NEW-Portability - IRS is allowed to grant hardship exceptions in Aequity or good conscience@ for distributions after 2001. Congress requested the IRS to issue guidance with objective standards for a waiver.