VEDDER PRICE

Employee Benefits Bulletin

A review and analysis of recent developments affecting employee benefits

Questions about the topics discussed may be directed to the article's authors, the Bulletin's Editor, Thomas G. Hancuch, or the firm's Employee Benefits Practice Group Leader, Paul F. Russell or any other Vedder Price attorney with whom you have worked.

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CORRECTING OPERATIONAL ERRORS IN QUALIFIED PLAN ADMINISTRATION

Despite everyone's best efforts, mistakes occur in administering qualified plans. The possibilities are almost endless. For example, a plan administrator often depends on others for receiving accurate data about hire dates, job transfers, salary levels, etc.

Everyone acknowledges that such mistakes should not threaten the qualified status of the plan. More importantly, it is in everyone's best interests to involve plan sponsors actively in their correction. The problem has been to construct a system that will efficiently accomplish those goals.

Over the last several years, the IRS has attempted to construct a way for plan sponsors to correct mistakes made in administering qualified benefit plans. In fact, the IRS has devised several procedures which were combined in 1998 into the Employee Plans Compliance Resolution System ("EPCRS") in Revenue Procedure 98-22.

That procedure, however, provided very limited correction methods to resolve the most common types of operational problems. In response to demands for more such advice, the IRS has provided additional guidance with Revenue Procedure 99-31.

While the methods set forth in the revenue procedures are not the exclusive means of correcting the stated problems, they provide a path many plan sponsors will want to consider. More importantly, as the number of specified methods grows, they will provide a solid base for devising solutions to the myriad variations of problems that arise in daily plan administration.

Set forth below are three examples of problems and their resolution, as outlined in the latest revenue procedure. From these selective examples, we can begin to see how the IRS intends to approach these types of situations.

401(k) Testing Violations

Under the tests applicable to 401(k) plans, highly compensated employees have limits placed on the amounts that they can elect to defer to their accounts in a given year. If those amounts are exceeded, then the plan has a specified time period to return the "excess" contributions to those employees. But, despite everyone's best efforts, situations occur where the refunds are not timely determined or made.

The original correction method for this type of problem required the employer to make additional contributions to the non-highly compensated employees until the test was passed. (This could involve a substantial contribution.) Under the new revenue procedure, the IRS has expressly approved what has come to be called the "one-to-one" method for such mistakes. Under that approach, the excess contributions (adjusted for earnings) are distributed to the affected highly compensated employees. In addition, the employer is required to make a special contribution to the plan in the same amount as the distribution. This special employer contribution is then allocated solely to the accounts of the non-highly compensated employees based either (1) on participant compensation in the year of the mistake, or (2) on a *per capita* basis to such employees for that year.

Improper Exclusion of a Participant from 401(k) Plan Participation

A second situation that can happen in 401(k) plans is the exclusion of an eligible participant. For a wide variety of reasons, it happens from time to time that an employee was not brought into the plan at the appropriate time.

As a result, the employee was not aware of the opportunity to make a 401(k) election for that period. The original correction procedure only dealt with a complete exclusion for an entire plan year. Under the new revenue procedure, a similar rule applies for a partial year exclusion. In either case, the employer can make a contribution to the account of the improperly excluded employee equal to the average contribution (on a percentage basis) of his group (either highly compensated or non-highly compensated) for the appropriate period multiplied by the employee's compensation for the excluded period. That amount is reduced, however, if, when added to deferrals the participant was allowed to make in the same plan year, the total exceeds the maximum deferral permitted under the plan for the year. The contribution must include an adjustment for earnings, as described in the procedure.

Further, if the employee did have a chance to contribute for at least nine months of the plan year, and during that time could have contributed the maximum amount, then there is no contribution due for the failure.

Improper Calculation of Plan Forfeitures

As a third example, sometimes plan administrators have made forfeiture calculations that are not in accordance with the vesting schedule, as contained in the plan document. Often such mistakes result from the imprecise calculation of a participant's years of service, which causes the plan administrator to select the wrong vesting percentage from the applicable table. This situation is not covered by the original procedure.

The new revenue procedure permits two methods for correcting violations of this type. First, the employer can make a supplemental contribution equal to the amount improperly forfeited, adjusted for earnings. Second, the amount improperly forfeited can be retrieved from the accounts of those participants who received the additional amount.

Conclusion

These and the other examples of the acceptable correction methods provided in the recent revenue procedure represent a good beginning toward a resolution of the types of problems frequently encountered by plan administrators. First, this approach recognizes that plan administrators are the best source to ensure the correct operation of the plans. Given the appropriate tools, they will act promptly and effectively to resolve these issues.

Second, the wide variety of things that can go wrong is almost endless. It is hoped that the IRS will issue additional guidance that goes beyond specific and detailed corrections, and establish broad parameters for correcting operational errors. This would allow a certain amount of discretion to plan administrators so that they can be proactive in managing and correcting the plans under their control.

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SECTION 415(e) COMBINED PLAN LIMITS REPEAL

The IRS recently issued guidance on the repeal of Internal Revenue Code Section 415(e). That section limits contributions and benefits of employees who participate in both a defined benefit plan and a defined contribution plan maintained by the same employer. The IRS guidance, in the form of IRS Notice 99-44, highlights the need for employers who maintain both defined benefit and defined contribution plans to examine the need for possible plan amendments before the end of the current limitation year. The potential impact of Section 415(e)'s repeal on nonqualified excess benefit plans also requires attention.

At the core of the new IRS guidance is the prospect that some participants' qualified retirement plan benefits may increase as a result of the repeal of Section 415(e) by the Small Business Job Protection Act of 1996 ("SBJPA"). The repeal is effective for limitation years beginning on or after January 1, 2000. This article briefly describes some of the principal issues addressed in IRS Notice 99-44.

Who gets the bigger benefit?

Notice 99-44 clarifies that any increase in benefits caused by the repeal of Section 415(e) only applies to benefits paid after the effective date of the repeal. An individual who has received in a lump sum all benefits payable before the effective date of the repeal will be unaffected. In contrast, a defined benefit plan may provide for benefit increases to a participant who is in pay status when the repeal of Section 415(e) becomes effective.

How will a plan's terms affect the benefit increase?

Plan sponsors have some control regarding how the repeal of Section 415(e) will affect their plans. For example, if a plan document incorporates the Internal Revenue Code Section 415 rules by reference only, the repeal of Section 415(e) may cause the benefits of certain individuals to automatically increase as of the effective date of the repeal. This, in turn, may increase the employer's funding obligation. If the employer wishes to avoid this immediate increase in funding liability, it will need to amend the plan *before* the effective date of the repeal to postpone or eliminate the application of the Section 415(e) repeal. IRS Notice 99-44 provides sample language to accomplish this result.

Alternatively, if the plan document recites the Section 415 (e) rule (as many plans do), rather than simply incorporating it by reference, the employer has at least two options: (1) postpone any decision regarding the application of the repeal of Section 415(e) until the last day by which tax-qualified plans must be amended to comply with the SBJPA, which has been extended by the IRS for most plans until the last day of the first plan year beginning on or after January 1, 2000 (*i.e.*, the end of the remedial amendment period); or (2) operate the plan in a manner consistent with the repeal of Section 415(e), accepting any corresponding increase in benefits and funding liability, and make any necessary conforming amendments by the end of the remedial amendment period.

What are the perils of ignoring the Section 415(e) repeal?

An employer that elects to continue the pre-repeal Section 415(e) limitations after the effective date of the repeal must carefully administer the plan to avoid inadvertently violating a variety of plan qualification requirements. For example, applying the pre-repeal rules after December 31, 1999, could easily result in unintentional excess contributions to suspense accounts or the inappropriate refund of elective deferrals in defined contribution plans – both of which are potentially disqualifying plan administration defects.

An employer maintaining a nonqualified excess benefit plan should examine the potential impact of Section 415 (e)'s repeal on the excess plan. For example, the repeal could create potential "double dipping" if the excess plan benefit has been paid in a lump sum prior to the effective date of the repeal without taking into account any increase in future annuity payments under a qualified plan resulting from the repeal. An amendment of either the excess or qualified plan may be required to prevent this result.

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401(k) TESTING PROCEDURES

Beginning with the 1997 plan year, nondiscrimination testing for 401(k) plans can be performed by using the current year method or the prior year method. Under the prior year method, contributions made on behalf of highly compensated employees for the current (or tested) plan year are measured against those made on behalf of nonhighly compensated employees for the prior plan year. Although a plan can always switch to the current year method, there are limitations on switching to the prior year method after the 2000 plan year.

In general, we have found that prior year testing provides more certainty for employers because they know what the highly compensated employee contribution limit will be at the beginning of the plan year. However, employers whose plans are experiencing increased contribution trends by nonhighly compensated employees often prefer current year testing. This is because the highly compensated employees do not have to wait a year to be able to utilize the corresponding increase to their contribution limits.

In approaching plan amendments involving 401(k) testing procedures, employers should consider the following:

1. The testing method utilized by a plan must be specified in the plan document. If an employer has switched testing methods since 1997, this also needs to be reflected in the plan document when it is updated.

2. If an employer wants to change from current to prior year testing, the change can be made by the 2000 plan year without complying with special IRS limitations.

3. Safeharbor designs that negate the need to test pre-tax or matching contributions do not extend to voluntary after-tax contributions. Therefore, safeharbor plans with after-tax contributions must still be tested. Also, the IRS has indicated that these contributions must be tested under the current year method.

4. Beginning in 1999, plans with liberal eligibility standards may exclude from testing nonhighly compensated employees who have not yet attained age 21 or completed one year of service.

5. Beginning in 1997, the method of making refunds to highly compensated employees when the nondiscrimination test is not met changed. The total amount to be refunded is still determined by calculating the total amount of excess contributions. With one exception, this is done the same way that it was before 1997. That is, the highest contribution percentage level for highly compensated employees is reduced to the next level, and so on, until the test is satisfied. Before 1997, this method was also used to determine the amount refunded to highly compensated employees. Now, it is only used to determine the total amount that will be refunded to

the highly compensated employees, and the actual amount that is refunded is now based on which highly compensated employees have the highest dollar level of contributions.

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GROUP LIFE INSURANCE UNIFORM PREMIUM RATE CHANGES

The Internal Revenue Service ("IRS") has issued new regulations reducing the imputed cost of group term life insurance. The new regulations require action by all employers providing more than $50,000 in group term life insurance coverage. The regulations also require employers offering employee-pay-all life insurance policy arrangements to reexamine the payroll tax treatment of those arrangements.

Table I – Treas. Reg. §1.79-3(d)(2)

	Monthly Cost per $1,000 of Insurance	
Age Group	**Old Table I ($)**	**New Table I ($)**
Under 25	25-29 Rate Applies	.05
25 to 29	.08	.06
30 to 34	.09	.08
35 to 39	.11	.09
40 to 44	.17	.10
45 to 49	.29	.15
50 to 54	.48	.23
55 to 59	.75	.43
60 to 64	1.17	.66
65 to 69	2.10	1.27
Over 70	3.76	2.06

Table I Changes

Generally, the cost of providing the first $50,000 of group term life insurance to an employee is excluded from the employee's income. The cost of employer-provided coverage in excess of $50,000 is includable in the gross income of the employee to the extent it exceeds the amount, if any, paid by the employee for the coverage. The "cost" of such coverage for determining the amount of imputed income is calculated using the IRS' uniform premium table ("Table I").

The new regulations make several notable changes. The old rates have been reduced substantially, due to changes in mortality assumptions. This means that the imputed cost of providing group term life insurance will be reduced for employees in each age bracket.

Additionally, the new Table I has eleven age brackets, adding a new bracket for employees under 25. Formerly, all employees under age 30 were subject to the same rate under Table I. Although the effective date of the final regulations is July 1, 1999, the IRS is allowing employers to use ten age brackets for the remainder of 1999 to minimize impact on employers' payroll systems while any year 2000 modifications are being completed. In other words, an employer may elect to apply the new five-year bracket for ages 25-29 to all employees under age 30. This election will result in a slightly higher taxable income for those individuals who are under age 25 for the balance of 1999 than they would otherwise have under the new eleventh bracket.

Imputed income from group term life insurance in excess of $50,000 continues to be subject to Federal Insurance Contribution Act ("FICA") withholding, but is not subject to federal income tax withholding. Although the change in Table I rates became effective July 1, 1999, employers will have until the last pay period of 1999 to make the necessary adjustments to FICA withholding resulting from the Table I rate changes.

Employee-Pay-All Policies

Significantly, the new regulations also increase the likelihood of imputed taxable income under employee-pay-all policies. A life insurance policy is considered "carried directly or indirectly by an employer," and thereby subject to Table I rates if either (a) the employer pays a portion of the premium, or (b) the employer arranges for payment of the premium and at least one employee is charged *less* than the applicable Table I rate and at least one other employee is charged *more* than the Table I rate.

The old Table I rates were well above the market rate for insurance, making it unlikely that any employee was being charged more than the Table I rate. Therefore, employee-pay-all policies arranged by the employer normally did not result in imputed taxable income. With the introduction of the new lower Table I rates, it becomes more likely that employees may "straddle" the Table I rates. As a result, employee-pay-all policies which were exempt from inclusion in employee's gross income may have to be recharacterized as subject to Table I rates.

The IRS has provided a transition rule for group term life insurance policies in existence on June 30, 1999, which allows employers to continue using the old Table I rates until January 1, 2003 for the purpose of determining if a policy is carried directly or indirectly by the employer. This will allow those policies not previously considered carried directly or indirectly by the employer to continue as such for another three years, as long as premiums do not "straddle" the old Table I rates.

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NEW COBRA ELECTION PROCEDURES

Many employers are preparing to take advantage of a new COBRA election procedure that becomes effective next year. Currently, employers must offer separate COBRA elections for different types of health benefits, such as medical, dental and vision. However, next year employers can begin offering an *all or nothing* election, so that a person electing COBRA coverage cannot pick and choose between separate benefits. For example, under the new rules, a former employee with both medical and dental insurance coverage could be prohibited from electing to continue only dental or only medical.

To take advantage of this new election procedure, and thereby minimize the adverse claims experience created by COBRA, an employer must offer the health benefits under a single governing plan document. This can be accomplished even if benefits are provided through different insurers or third party administrators by utilizing a *wrap-around welfare plan document*. The *all or nothing* election will not be possible if the medical and dental benefits are treated as two separate plans. Adopting a wrap-around document not only enables an employer to take advantage of this new COBRA procedure, but also helps ensure compliance with ERISA's plan document and disclosure requirements.

Other recent COBRA changes are described in the March 1999 edition of Vedder Price's *Employee Benefits Bulletin*, available on our website at *www.vedderprice.com*.

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MONITORING THE ESOP NONALLOCATION RULE

Background

An employee stock ownership plan ("ESOP") often acquires shares of company stock in a tax-deferred sale under Section 1042 of the Internal Revenue Code of 1986 ("Code"). Generally, capital gains tax can be avoided by a person (other than a corporation) who sells company stock to an ESOP if certain requirements are satisfied. Among other requirements, the stock must be held for at least three years and the seller must purchase *replacement securities* (*i.e.*, stocks or bonds of another domestic operating corporation) within 12 months after the date of the sale. However, in a Section 1042 transaction, the shares acquired by an ESOP in the transaction may not be allocated to the selling shareholder, his ***family members*** or ***25% owners***. Because this nonallocation rule imposed by Code Section 409(n) is easily violated by closely held corporations, and violations can result in sanctions, we offer the following brief refresher for our ESOP clients and friends.

Persons Covered by the Nonallocation Rule

25% owner generally is defined as a person who owns more than 25% of: (1) any class of stock of the company sponsoring the ESOP (based on the number of shares outstanding in, or the total value of, the class of stock), or (2) any class of stock of any other corporation (based on the number of shares outstanding in, or the total value of, the class of stock) of which the company sponsoring the ESOP owns 50% or more. Ownership is considered not only as of the sale date, but also at any time during the one-year period prior to the date of the sale to the ESOP or a date when an allocation of shares of company stock is made to ESOP participants. Significantly, stock owned by a person's spouse, children, parents and grandparents is included in determining whether that person is a 25% shareholder.

> ***Example:*** LM, Inc. is owned by the following three unrelated individuals: Greg (40%), Hank (40%) and Isaac (20%). LM has only one class of stock outstanding. Greg and Hank sell their shares to an ESOP, while Isaac does not. Greg and Hank are precluded from receiving allocations under the ESOP because they are selling shareholders. However, since Isaac is neither a selling shareholder, family member nor 25% owner, he is not precluded from receiving an allocation. Note, however, that in the future Isaac could become a 25% owner by including the shares allocated to him in the ESOP, stock options, or acquiring additional shares.
>
> ***Example:*** Assume the same facts as above, except that the stock sold by Greg and Hank to the ESOP had been recapitalized into a different class of stock (Class B) immediately before the sale, thereby leaving Isaac with all of the outstanding shares of Class A stock. This makes him a 25% shareholder, since he owns more than 25% of a class of stock, even though he owns less than 25% of the total equity of LM. Therefore, in this example, Isaac is ineligible to receive an allocation under the ESOP.

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Family members include the selling shareholder's siblings (including stepbrothers and stepsisters) spouse, parents, grandparents, children (including adopted children) and grandchildren.

Exceptions for Certain Family Members

A narrow exception to the prohibited allocation rule is made for children and grandchildren who are not otherwise 25% owners for up to 5% of the shares sold to the ESOP in a Section 1042 transaction by their parents or grandparents. In addition, the prohibited allocation rule applies only to the selling shareholder and family members during the 10-year period beginning on the date the shares were sold to the ESOP, or until the last allocation due to the final ESOP loan payment is made, whichever is longer. This means that forfeited shares or shares that are recycled through the ESOP may be reallocated to the selling shareholder and his family members after the nonallocation period ends, unless they are also 25% shareholders.

If a participant is a family member for one Section 1042 transaction (Transaction #1) and not another transaction (Transaction #2), then he or she can receive an allocation of shares purchased in Transaction #2. However, because the nonallocation rule applies on a direct or indirect basis, the amount of shares allocated to the participant cannot be increased to take into account the shares that were not allocated relating to Transaction #1.

> ***Example:*** For the 1999 plan year, an ESOP has 500 shares to allocate to the accounts of its participants. The allocation process is done pro rata, based on compensation. Lisa's compensation is 5% of the total compensation, so she would normally receive an allocation of 25 shares (500 x 5%). Lisa is not a 25% owner. However, Lisa is a family member with respect to 100 of the 500 shares. As a result, she can receive an allocation of only 20 of those shares (400 x 5%). Furthermore, she cannot receive a make-up allocation corresponding to the other five shares through a qualified retirement plan.

In contrast, the nonallocation rule for a 25% shareholder is a complete prohibition. Accordingly, neither a 25% shareholder nor his or her covered relatives may ever receive an allocation of shares acquired by an ESOP in a

Section 1042 transaction.

> ***Example:*** Tom Sr. and Don Sr., who are not related, each owns 50% of AB, Inc. Their sons, Tom Jr. and Don Jr., also work at AB. Tom Sr. and Don Sr. each sell 20% of their stock to an ESOP in a Section 1042 transaction, so the ESOP owns 40% of AB. Although neither Tom Jr. nor Don Jr. owns any stock in AB directly, they are deemed to own their fathers' stock, and each father still owns 30% of AB. Since this makes them 25% owners, the 5% exception for lineal descendants does not apply. Even if their fathers had sold 80% of their stock to an ESOP, Tom Jr. and Don Jr. would still be 25% owners, since they were considered to be such during the one-year period prior to the sale.

Conclusion

The Section 1042 tax incentive is usually very valuable to a selling shareholder and, thus, a driving force behind ESOP transactions. Like many other tax incentives, there are strings attached to Section 1042 that necessitate careful planning. The ESOP nonallocation rule is a prime example of this. Although failure to comply with the nonallocation rule will not necessarily invalidate a Section 1042 election, it will result in adverse tax consequences to the participants who receive the prohibited allocation. It could also undermine the status of a plan as an ESOP. Accordingly, ESOP plan sponsors should ensure that proper procedures are in place to ensure compliance with the ESOP nonallocation rules.

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MARKETABILITY DISCOUNTS AND ESOP VALUATIONS

A federal district court in Ohio recently issued one of the first published decisions explicitly accepting a low marketability discount in an ESOP valuation. A marketability discount is often applied when an appraiser determines the fair market value of nonpublicly traded stock to reflect the fact that the stock cannot be readily sold to a third party. The issue of the appropriate amount of a marketability discount in an ESOP valuation has been a controversial topic due to earlier court decisions. Accordingly, the recent case is good news but, as explained below, not necessarily conclusive.

When stock appraisals are performed for estate or gift tax purposes, the marketability discount can be significant. Usually, a discount of *at least* 25 to 30% is applied to reduce the fair market value of the stock and, hence, the amount of estate and gift tax owed. Appraisers usually apply smaller, and often no, marketability discounts in ESOP transactions, based on the rationale that since a person receiving a stock distribution from the ESOP can require the employer to repurchase the distributed stock (through a process known as the *put option*), a market is essentially created for the stock. Accordingly, under this rationale, no marketability discount is warranted. In the ESOP context, applying a higher marketability discount reduces the potential sales price by the person selling stock to the ESOP. Although most sellers understandably want to obtain the highest price possible, selling stock to the ESOP in excess of fair market value (as determined by an independent appraiser) is not legal.

The recent decision in *Reich v. Hall Holding Company* involved the damages suffered by an ESOP for paying more than fair market value when purchasing company stock. The court ruled last year that the ESOP fiduciaries violated ERISA by not making a prudent investigation into the price before causing the ESOP to purchase the stock. At that time, the court deferred any ruling on the fair market value of the stock and the amount of the ESOP's damages, if it overpaid for the stock.

Following a hearing on these issues, the court applied a 5% marketability discount, rejecting the defendants' argument that no marketability discount should be applied, due to the availability of the ESOP put option. The court explained that ESOP participants could not get distributions until they terminated employment, they might have to receive put option payments over time, and they were exposed to the risk that the company's financial condition could preclude it from honoring its put option obligations. These circumstances, the court explained, justified application of a marketability discount.

Other courts in earlier cases have taken the position that an ESOP put option does not necessarily eliminate the need to apply a marketability discount. In a 1996 case, *Eyler v. Commissioner*, an ESOP valuation was not performed, and the controlling shareholder instead relied on a valuation previously used for a failed initial public offering in selling his stock to an ESOP. The court of appeals in *Eyler* said that the ESOP put option could not be used to justify avoiding a marketability discount because the put option was not based on a fixed price, and could be paid over a five-year period. A similar conclusion was reached in a 1995 district court case, *Conner v. Mid South Insurance Agency*, where the plan document lacked the necessary put option provisions required by the Internal Revenue Code plan qualification rules.

Because of the negative facts present in *Eyler* and *Conner*, many ESOP practitioners have dismissed them as unlikely to be controlling in litigation if a valuation is done prudently. Some practitioners also have relied on proposed Department of Labor ("DOL") regulations addressing ESOP valuations. The proposed regulations suggest that a put option may reduce a marketability discount, but require the fiduciary to assess the viability of the put option.

One recent federal district court decision in Illinois appeared, at first glance, to give deference to the DOL proposed regulations, which are ordinarily not controlling in litigation, given their "proposed" status. In *Montgomery v. Aetna Plywood, Inc*., the ESOP's stock was being redeemed by the company-sponsor, and the plaintiffs claimed that the ESOP received less than fair market value. The court, holding in favor of the plaintiffs, rejected the defendant's position that the stock should have been valued with a marketability discount (application of the discount would have supported the lower sales price paid to the ESOP). Although this appears to be consistent with the DOL's proposed regulations, the court explained that, since the stock being redeemed by the company would no longer be "burdened by a 'put' option," the discount was not warranted. This can be read to imply that the put option does not always have the effect of reducing the marketability discount. Alternatively, perhaps this case can be read to support the proposition that a different analysis applies when an ESOP is selling stock, as opposed to when it is purchasing stock.

There have been unconfirmed reports that the Internal Revenue Service ("IRS") is auditing ESOPs looking for a test case on the ESOP marketability issue, and that the IRS believes that ESOP marketability discounts should be higher than 5%, but perhaps not as high as in the estate and gift tax context. Both the IRS and the DOL have jurisdiction over ESOP valuations. In the context of the IRS's reported position and the proposed status of DOL regulations, the recent *Hall Holdings Company* decision looks promising.

The pattern that is developing in these cases appears to be that courts will subject fiduciaries who do not follow proper procedures to stringent standards in reviewing ESOP valuations used in transactions. There have been countless ESOP stock purchase transactions completed with very small, if any, marketability discounts being applied, and with no adverse repercussions to fiduciaries. Hopefully, the reported decisions with negative facts will not have a spillover effect on transactions where fiduciaries make prudent decisions on behalf of the participants.

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