January 21, 2005

GENERAL

Stevenson Keppelman Associates is primarily an employee benefits law firm. We are pleased to serve you in this capacity. Because of our specialization and “no-nonsense” approach, we are able to offer deep expertise and high quality work, but at below market rates.

As part of our no frills approach, we don’t pester you with constant newsletters. But from time to time, we must advise you of developments that may require your specific action, or which may offer you new opportunities. This is one such occasion. There are a number of items in this newsletter which require your immediate attention and decisions. Please contact us promptly regarding any of the items which apply to you. If you are unsure about any item, please err on the side of caution and give us a call.

BEFORE WE GET DOWN TO BUSINESS, SKA WELCOMES MICHELLE KAUPPILA!

Michelle Kauppila has been working with us since March of this year. She graduated with honors from Chicago-Kent College of Law in 2003. She received her Bachelor of Arts in Economics from the University of Michigan and a Master of Science in Accountancy from DePaul University. Michelle became a Certified Public Accountant in Illinois in 1996.

Michelle has nine years of experience working in defined contribution pension plan administration and bank trust administration. She continued to work full-time as a Pension Administrator during law school. Prior to joining Stevenson Keppelman Associates, she worked as a law clerk in the Employee Benefits Department of a labor and employment law firm in Chicago, Illinois. These experiences make Michelle very good at retirement plan design, investing and administration.

Michelle recently passed the Michigan bar exam and has been admitted to practice in Michigan. She is also admitted to practice in Illinois.

Michelle grew up in Detroit, and currently lives in Canton with her husband, Eric, and their children, Jacob, Emma, and Abigail. The family will be moving to Milan in the summer of 2005.

QUALIFIED RETIREMENT PLANS

1. AUTOMATIC IRA ROLLOVERS - *PROMPT ACTION REQUIRED*

In the 2001 Tax Act (EGTRRA), Congress added an "automatic rollover rule", requiring retirement plans to automatically rollover into traditional IRA's any automatic lump sum ("cash-out") amounts between $1,000 and $5,000 IF the participant does not elect a different distribution method. This new law was to be effective after the Department of Labor issued final regulations, giving plan fiduciaries guidance on the choice of IRA's and IRA investments. Those regulations were issued on September 27, 2004. So the new "automatic rollover rule" will apply to mandatory distributions made from qualified plans (and perhaps other tax-favored retirement programs) beginning March 28, 2005. By then, retirement plans must either be amended to include the automatic rollover rule, or must be amended so as to avoid the automatic rollover rule.

Many of our clients like automatic cash-out provisions. They are currently permitted on benefits as large as $5,000. For example, if a terminated participant has an account or a pension benefit with a present lump sum value of $4,500 at the time of termination, the retirement plan could force a lump sum distribution, thus ending administration with respect to that participant, and recognizing other savings. Unfortunately, automatic cash-outs greater than $1,000 will now be subject to the new direct IRA rollover rule, thus adding additional administrative effort in order to achieve the cash-out. That effort would include the selection, as a fiduciary, of an IRA custodian and choice of IRA investment!

So we have the following choices:

- lower your cash-out limit to $1,000. That will avoid the automatic IRA rollover rules, but will allow more participants to require that their accounts or pension benefits remain in your plan after they terminate employment. (There are some things we could do about this, however. See item 9 below.)
- leave the cash-out limit at $5,000, but comply with the new IRA rollover rules.

Either way, your plan and summary plan description will need attention. We will either (1) lower the limit to $1,000, or (2) provide for new IRA rollovers and help you with the new procedures. In order to meet the March 28 deadline, you must act promptly. Please contact us as soon as possible so that we may help you with your decision and do the necessary documentation.

Plans Covered. These IRA rollover rules clearly apply to qualified retirement plans of private employers. There is some suggestion that the rule may even apply to other plans, such as 403(b) plans, 457 plans, and even qualified plans of governmental employers which are not regulated by ERISA. The statute as passed by Congress would not seem to reach plans that are not qualified plans (such as 403(b) and 457 plans). Nor would it seem to reach non-ERISA plans (such as governmental and church plans). Nonetheless, it seems that the IRS is trying to overreach into these plans. If you fall within those categories (for example, if you are a governmental employer), please contact us so that we can form a strategy.

WHAT TO DO? Contact us ASAP to provide for IRA rollovers, or to avoid them.

2. DISCLOSURE OF RELATIVE VALUES OF OPTIONAL FORMS OF PAYMENTS IN DEFINED BENEFIT PLANS

Defined benefit pension plans must distribute benefits in the form of a single life annuity for unmarried participants and a joint and 50% survivor annuity for married participants. (These rules are commonly referred to as the qualified joint and survivor rules, or automatic form of payment rules.) If participants may elect other forms of payment, the plan must disclose to the participant and spouse (if applicable) the financial effect of waiving the automatic form of payment. Beginning for distributions starting last October, regulations require that plans provide specific details about the relative values of different forms of payments. Usually, different options have the same actuarial value, but the options can have different actuarial values if there is a lump sum option, or there are subsidized early retirement benefits.

WHAT TO DO? If you are an ERISA pension plan and you have not already discussed these rules with us or with your administration firm, please contact us right away. Changes in plans and administrative forms, may be needed.

3. RETROACTIVE ANNUITY STARTING DATES FOR DEFINED BENEFIT PLANS

The explanation of the automatic single life annuity or joint and 50% survivor annuity described above must be given to the participant and spouse 90 days before the "annuity starting date". The participant and spouse can consent to have the pension start sooner than 90 days after they receive the explanation. Unfortunately, participants often fail to give plan administrators enough notice that they want the pension to begin in order for the plan to provide the explanation before the annuity starting date. Plans must now either

(1) allow a "retroactive annuity starting date" and permit participants to choose between starting benefits (a) after they receive the explanation (based on the participant's age and current spouse on that date), or (b) on the original, "retroactive" date, based on the participant's age on the retroactive date but the current spouse, with a make-up payment, including interest, or

(2) not allow retroactive annuity starting dates at all.

A plan which does not allow retroactive annuity starting dates must be sure participants always receive an explanation of the automatic form of payment before the annuity starting date. These rules have been effective throughout 2004. Again, if you are an ERISA pension plan and you have not already discussed these rules with us or with your administration firm, please contact us right away.

Note that there is no "retroactive annuity starting date" problem if a plan provides a participant with the proper explanation at the proper time, but for whatever reason, the pension begins after the "annuity starting date". In that case, the plan should automatically pay a "make-up payment for the missed months, and then continue monthly payments thereafter.

Also note that where a plan permits a lump sum payment and the participant elects it, the plan may provide that the lump sum will be based on the participant's age and the actuarial factors in

place on the date of the distribution, regardless of the "annuity starting date" or when the participant received the explanation of the automatic form of payment.

WHAT TO DO? Contact us if you are an ERISA plan and have any doubts about compliance.

4. MINIMUM REQUIRED DISTRIBUTION RULES

The IRS has issued a mind-boggling succession of rules on required minimum distributions from retirement plans. "Final" regulations were issued in both April 2002, and again in June, 2004!

The final regulations issued in April 2002 and those issued in June 2004 apply for determining required minimum distributions for calendar years beginning on or after January 1, 2003. The deadline to amend defined contribution plans to conform to the final required minimum distribution rules was the later of the last day of the plan year beginning in 2003 or the deadline to adopt amendments to conform to GUST. However, the IRS postponed the deadline to amend defined benefit plans to conform to the final required minimum distribution rules. The extended deadline is the end of the EGTRRA remedial amendment period, which ends "not prior to the last day of the first plan year beginning in or after January 1, 2005.

Needless to say, all these recent changes and deadlines to comply with the minimum required distribution rules is a source of great confusion. We will continue to monitor developments in this area.

WHAT TO DO? If we are responsible for your retirement plan's tax compliance, we will amend it as needed. You should contact us to confirm correct plan administrative procedures are being followed.

5. NEW U.S. DEPARTMENT OF LABOR ("DOL") GUIDANCE ON THE PAYMENT OF PLAN EXPENSES

A retirement plan's expenses can be paid directly by the employer or they can be paid from the assets of the plan. Many sponsors of defined contribution (individual account) plans have elected to have participants' accounts bear some of the costs of maintaining the plan.

It had been the DOL's position that most plan expenses had to be shared by participants accounts on some equal basis. This seemed unreasonable, for example, in the case of a divorced participant, the costs of whose QDRO would either be paid by the employer, or shared by other participants! Recently, the DOL issued guidance changing its position on charging individual participant's accounts for certain plan-related expenses. The DOL's new position is that plan sponsors may (1) pass along plan-wide expenses to all participants on either a pro rata or per capita basis, depending on the circumstances, (2) allocate certain expenses directly to the accounts of participants who incurred the charge (e.g., processing hardship withdrawals, qualified domestic relations orders), and (3) allocate to terminated vested participants their share of administrative expenses, even if the employer pays such

expenses for active participants. (Item 3 can be helpful in encouraging terminated participants to take distributions, and thus can reduce the impact of the direct IRA rollover rules. See item 1 above.)

WHAT TO DO? This is an important time to review your policy on payment and allocation of plan expenses with an eye towards shifting some of the costs of maintaining the plan. This is especially true for certain expenses directly allocable to a specific participant. At a minimum, we should (i) review your methodology for allocating plan expenses; (ii) amend the plan document, if needed; and (iii) revise the summary plan description as required to inform participants of changes in policy and to summarize fees that will be charged to accounts and the method of charging the fees.

6. NEW CHALLENGES FOR ERISA SECTION 404(c) COMPLIANCE IN RESPONSE TO MUTUAL FUND ABUSES

Recent mutual fund trading practices have raised particular concerns for retirement plan sponsors who maintain defined contribution individual account ERISA Section 404(c)[1] plans. These are plans that allow participants to direct the investment of their accounts among investment choices which typically include mutual funds. Mutual fund trading irregularities, especially late trading and market timing abuses, prompted the Securities and Exchange Commission ("SEC") to issue new rules that complicate compliance with ERISA Section 404(c). In response, many mutual funds have introduced minimum holding periods, or have early sales charges. Many third party administrators have introduced limitations on the number and frequency of investment changes. The changes do not always dovetail with ERISA Section 404(c) compliance. Thus, the DOL issued new guidance to assist plan fiduciaries with ERISA Section 404(c) compliance.

If a plan's investment alternatives include mutual funds under SEC investigation, the DOL advises plan fiduciaries to contact the fund provider and obtain specific information about the allegation. This is because plan fiduciaries may need to consider actions to remedy any adverse financial effect on participant investments. Fiduciaries are encouraged to review the practices of participants to determine whether there is evidence of market timing or excessive or late trading. If abuses are discovered, fiduciaries may need to implement appropriate trading restrictions to protect the participants. This may require implementing additional levels of monitoring and recordkeeping. Market timing and late trading issues raise collateral concerns related to the imposition of blackout periods (whenever participants can't make changes for 3 days or more). Previously, blackout periods might have arisen during a change in recordkeepers or investment alternatives. Now fiduciaries must consider whether trading restrictions imposed by the third party administrator, the mutual fund or the plan itself raise a blackout issue.

These are just a few of many issues raised by the interaction of new SEC rules, ERISA 404(c) compliance, and the DOL guidance on fiduciary duties in response to mutual fund

[1] ERISA Section 404(c) compliance allows the plan's investment fiduciary to shift to participants much of the responsibility for investment decisions thereby escaping much of the potential liability for those decisions.

trading abuses. These issues have implications for (i) plan design, (ii) plan operations, (iii) 404(c) participant-directed investment policy, and (iv) participant communications.

WHAT TO DO? If you are an ERISA Section 404(c) plan, you should counsel with us on these issues to maintain your important ERISA Section 404(c) protection, thereby minimizing your liability exposure for participant-directed investment losses.

7. EXTENSION OF REMEDIAL AMENDMENT PERIOD TO COINCIDE WITH EGTRRA REMEDIAL AMENDMENT PERIOD

Even though your plan has been updated to include amendments for EGTRRA (the 2001 Tax Act), the IRS will not yet issue a ruling letter that covers EGTRRA plan language. This "no ruling policy" on EGTRRA is problematic for plan sponsors who instituted a new plan, to include good faith EGTRRA amendments, after December 31, 2001 or adopted plan amendments to an existing plan after December 31, 2001 because it requires a plan sponsor to make two separate applications for determination letters: one for a ruling on tax qualification requirements unchanged by EGTRRA; the second, at a future date, for a ruling on EGTRRA plan language.

To avoid this situation, the IRS extended the regular remedial amendment period under Code Section 401(b) for new plans (put into effect after December 31, 2001) and plan amendments of existing plans (adopted after December 31, 2001), in each case to coincide with the remedial amendment period for EGTRRA. The EGTRRA remedial amendment period will end no earlier than the end of a plan's 2005 plan year. By extending the regular remedial amendment period to coincide with the EGTRRA deadline, plan sponsors of a new plan put into effect after December 31, 2001, which include good faith EGTRRA amendments, and plan sponsors who adopted plan amendments to existing plans after December 31, 2001, can defer filing for an initial or updated IRS ruling letter until the end of the EGTRRA remedial amendment period.

WHAT TO DO? If we are responsible for your plan's tax law compliance, we will contact you about an updated ruling. In the meantime, be aware of this ruling need.

WELFARE PLANS

8. NEW COBRA NOTICE REGULATION

All group health plans must follow new regulations on COBRA notices, which apply to their first plan year beginning after November 26, 2004 (January 1, 2005 for calendar year plans).

The requirements for two COBRA notices already used (initial notice and the election notice) are changed, and model notice forms have been provided. Two new types of notice are now required. Notably, plans must advise covered people of "reasonable procedures" that the

covered people must use to inform the plan administrator about certain COBRA events of which the plan administrator would otherwise be unaware (divorce, loss of dependent status, etc.)

The new COBRA notice procedures and other alternatives to continued coverage which may be available (conversion policy, separate retiree plan, etc.) must now be explained in a the plan's Summary Plan Description.

WHAT TO DO? As a result of this new regulation, plan sponsors must review the COBRA notices they (or their COBRA TPA) use, and update their group health plan SPD.

9. WORKING FAMILIES' TAX RELIEF ACT - DEPENDENTS

The recently-enacted (effective 1/1/05) Working Families' Tax Relief Act changed the tax code's definition of "dependent". While the most direct impact will be for claiming dependents on an individual's tax return, there are consequences for employee benefit plans too, because many plans reference the now-changed tax code definition of dependent or say that people may be covered if they are "tax dependents."

A tax dependent now must be either a "qualifying child" or "qualifying relative." Under the existing rule, a person was a dependent if they had an appropriate relationship with the taxpayer and the taxpayer provided more than half of that person's support. Under the new rule, a "qualifying child" must have a relationship with the taxpayer, be resident with the taxpayer for more than half the year (with the taxpayer no longer being required to provide more than half of the support) meet specified age limits and not provide more than half of their own support. A person who is not a "qualifying child" may be a "qualifying relative" if they meet a relationship or residency requirement, do not have their own income in excess of the dependency amount ($3100 in 2004) and receive more than half their support from the taxpayer. These same rules apply for purposes of determining who can receive tax-free coverage and benefits from a group health plan, except the income limit for a "qualifying relative" does not apply.

WHAT TO DO? As a result of this change, individuals need to review who they can claim as dependents on their tax return for 2005 and group health plans need to review their definitions of "dependents" to see that they cover only who they intend to cover, and people eligible to be covered now. Existing references to "tax dependents" of an employee will cause coverage under the plan to change, and result in imputed income for dependents of employees who are no longer considered "dependents."

10. HIPAA - SECURITY RULE

The requirements of HIPAA's "Administrative Simplification" provisions have phased in over the last several years (electronic transactions effective October 16, 2003; Privacy Rule effective April 14, 2003; (April 14, 2004 for small health plans). The next wave to take effect is a new HIPAA "Security Rule". While the already-effective Privacy Rule governs the

physical protection of Protected Health Information ("PHI"), the new Security Rule treats Electronic PHI ("EPHI"). HIPAA "covered entities" (health care providers, group health plans and health insurers) must comply with this new rule by April 20, 2005 (2006 for small plans). The Security Rule provides very detailed standards and explanation specifications for EPHI administrative, physical and technical safeguards.

WHAT TO DO? The new Security Rule requires group health plans to:

- assess their current electronic security risks and identity gaps
- develop an implementation plan that addresses all implementation specifications;
- implement solutions; and
- document their decisions.

11. HEALTH CARE DEVELOPMENTS

Recent legal developments have encouraged insurers to offer, and employers to sponsor, "High-Deductible Health Insurance Plans," with separate programs available to help employees meet the higher deductibles. Alternative supplemental arrangements (beyond the already-existing Health Care Flexible Spending Accounts with their unattractive "use it or lose it" rule) include: Health Savings Accounts (which are IRA-type trust accounts that can pay medical expenses and receive contributions from either individuals or their employers), and Health Reimbursement Arrangements (which must be funded through employer contributions)

Both HRA's and HSA's are permitted to carry a balance from one year to the next -- even after termination of employmen0074.

Coordination of any of these supplemental programs with a High-Deductible Health Plan needs to be done very carefully, and there are specific requirements for what a high-deductible health plan may provide.

12. USERRA PROPOSED REGULATIONS

The U.S. Department of Labor recently published draft regulations that interpret the Uniformed Services Employment and Reemployment Act of 1994 (USERRA). This is the veterans' rehire law. These regulations represent the first published interpretations of USERRA since the law was passed. While the DOL expressed its opinion that most employers are already in full compliance with the requirements of USERRA, the DOL expects that the regulations will be effective 30 days after their issuance in final form.

Under the regulations, during an employee's period of service in the uniformed services, he or she is deemed to be on furlough or leave of absence and is entitled to same non-seniority benefits to which employees on furlough or leave of absence are entitled. If such benefits differ depending on

the type of leave, then the employee is entitled to the most favorable treatment accorded to someone on a comparable form of leave.

USERRA provides for continuation of health coverage similar to, but not identical to, that provided under COBRA. A major difference is that USERRA extends the availability of continuation of health coverage to employees without regard to the size of the employer's workforce or whether the employer is a governmental entity. The maximum period of continuation of healthcare coverage under USERRA is generally the same or shorter than that provided under COBRA. The proposed regulations state that health plan administrators must develop reasonable requirements addressing how continuing coverage may be elected and reasonable procedures for payment, consistent with the plan and applicable law.

The proposed regulations also address pension benefits for employees returning from uniformed services, including when an employer is required to make plan contributions attributable to the period of military service, the repayment period and amount of contributory contributions or elective deferrals that the employee may make up to the plan, and how compensation during the period of military service is calculated to determine pension benefits for that period.

WHAT TO DO? Until the regulations are issued in final form, they are not binding upon employers. However, they do offer explanations to existing legal requirements under the law. Please contact us if you need assistance in determining your benefit obligations under USERRA for an employee or employees returning to work after military service or requesting continuation of health coverage during a period of military service.

13. HEALTH SAVINGS ACCOUNTS

Recent legal developments have encouraged insurers to offer, and employers to sponsor, "High-Deductible Health Insurance Plans," with separate programs available to help employees meet the higher deductibles. Alternative supplemental arrangements (beyond the already-existing Health Care Flexible Spending Accounts with their unattractive "use it or lose it" rule) include: Health Savings Accounts (which are IRA-type trust accounts that can pay medical expenses and receive contributions from either individuals or their employers), and Health Reimbursement Arrangements (which must be funded through employer contributions.) Both HRA's and HSA's are permitted to carry a balance from one year to the next - even after termination of employment.

A Health Savings Account (HSA) is a tax-exempt trust or custodial account established solely for the purpose of paying qualified medical expenses of the account beneficiary who is covered under a high-deductible health plan (HDHP) for the months for which contributions are made to the HSA. HSAs may be established for taxable years beginning after December 31, 2003. In general, qualified medical expenses may only be paid or reimbursed by an HSA if the expenses are incurred after the HSA has been established. Transitional relief exists for 2004 qualified medical expenses if an HSA is established by April 15, 2005.

To be eligible to establish an HSA, an individual, with respect to any month, (1) must be covered under a HDHP on the first day of such month, (2) must not be covered by any other health

plan that is not an HDHP; (3) must not be entitled to Medicare benefits; and (4) may not be claimed as a dependent on another person's tax return.

For 2005, a HDHP for self-only coverage is one that has an annual deductible of at least $1,000 and annual out-of-pocket expenses to be paid not exceeding $5,100. For family coverage, these amounts are a deductible of at least $2,000 and annual out-of-pocket expenses to be paid not exceeding $10,200. The maximum contribution to an HSA depends on several factors, including eligibility and health plan coverage, but may not exceed $2,650 for self-only coverage ($5,250 for family coverage) for 2005.

Employers may make contributions to an employee's HSA that are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from the employee's gross income. Certain nondiscrimination rules apply to HSA contributions made on behalf of employees. HSA contributions may also be made through a cafeteria plan.

WHAT TO DO? If you would like more information on these options, please contact us. If you already provide health coverage to employees under an HDHP, you may consider contributing to HSAs for your employees. If you would like to give employees an option of contributing to HSAs through your cafeteria plan, an amendment to your cafeteria plan will be necessary to allow for employees to elect to HSA contributions under the cafeteria plan. Since the general rule requires that an HSA may only pay or reimburse for medical expenses incurred after the HSA was established, action must be taken as soon as possible to allow for the most coverage in 2005. If you are interested in contributing to your employees' HSAs for 2004 medical expenses, such contributions must be made by April 15, 2005.

NONQUALIFIED DEFERRED COMPENSATION

14. NONQUALIFIED DEFERRED COMPENSATION CHANGES

In new Code Section 409A, Congress codified much of the IRS' traditional (and very strict!) view about the timing of elections to defer compensation. Elections to defer must be made *before the year* in which the compensation is earned, or at least six months before the end of the measuring period for performance-based deferred compensation earned over a period of more than one year. There are strict limitations on later changes in the election of the timing and form of payment, as well as new rules requiring that distributions begin no earlier than separation from service, death, disability, or a date specified by the plan before the deferral. The payment of deferred compensation may be accelerated only pursuant to regulations the IRS has not yet adopted.

If a plan violates these rules, the deferred compensation will be taxed when it is deferred. In addition, there is a "penalty tax" equal to 20% of the deferred compensation, plus interest based on the date the deferred compensation was deferred or became vested, if later.

WHAT TO DO? Before allowing deferrals of compensation to continue in 2005, you should review your nonqualified plans to be sure 2005 deferrals will comply with these new rules.

TAX-EXEMPT AND GOVERNMENTAL EMPLOYERS

15. COMPENSATION APPROVAL AT TAX-EXEMPT EMPLOYERS

Tax-exempt organizations may not pay unreasonable compensation to certain key personnel. Doing so could incur the ultimate IRS sanction, loss of tax-exempt status. More likely, “intermediate sanctions” under Code Section 4958 would be applied. The person receiving unreasonable compensation would be taxed at 25% of the excess benefit amount. If the matter were not promptly corrected, an additional tax of 200% would apply. Also, the “organization manager” that approved the compensation would face a tax of 10% of the excess benefit, limited to $10,000 per transaction. Finally, the tax-exempt employer would face unfavorable publicity.

In 2002, IRS finalized regulations under Code Section 4958. Those regulations prescribed procedures to be followed in approving compensation. By following the procedures, organization managers can be insulated, and a rebuttable presumption can be established that will reduce exposure to excise taxes and unfavorable publicity. In June 2004, IRS launched an aggressive enforcement program aimed at improving compliance with these rules.

We have worked with a number of tax-exempts in creating programs to comply with these rules. We have also applied the rules in specific instances, such as the installation of benefit programs for limited groups of key personnel. You must be aware of the rules and consider them in your compensation approval procedures. Ideally, your board would review compensation annually, which has special significance under the regulations. Interim compensation changes, new arrangements and new hires would also be reviewed. To the extent possible, we have searched for simplified ways to handle these procedures.

WHAT TO DO? If you are a tax-exempt employer, you should formalize and document procedures soon.

16. PROPOSED 403(b) ANNUITY REGULATIONS

In November, the IRS published proposed regulations on 403(b) annuities, incorporating decades of IRS rulings and guidance as well as many statutory changes. In general, these rules harmonize the rules for 403(b) annuities and 401(k) plans to the extent possible. The regulations require employers to exercise greater control over 403(b) annuity contracts, and to include many of the new rules in a written plan document. This requirement may cause 403(b) programs of tax-exempt employers, which have been exempt from ERISA under U.S. DOL regulations, to become subject to ERISA. (403(b) programs of public schools and universities will remain exempt from ERISA, but may nevertheless be required to incorporate new rules in a written plan document in order to assure compliance with tax rules.)

The proposed regulations also include:

- More flexibility on the rule that all employees must be able to elect to defer into the 403(b) program (the only nondiscrimination rule which applies to elective deferrals into 403(b) annuities.)

- The ability to terminate a 403(b) program and to distribute assets to participants (which is questionable under current tax rules).
- An ordering rule for catch up contributions. The special catch up for unused deferrals in the last three years before retirement will apply before the over-age-50 catch up rule.
- The ability to continue to make 403(b) contributions for five years after an employee has terminated employment.
- The first regulatory statement that non-profits will be part of a controlled group if one non-profit controls the board of another non-profit. If there is "board control", the two non-profits will be treated as a single employer for employee benefit purposes.
- A provision that the 403(c) tax rules (for "non-qualified annuities") will apply to non-vested contributions to 403(b) annuities until the contributions become vested, at which point the 403(b) tax treatment will apply. Essentially, this means that employees can elect under Code Section 83 to be taxed on the value of the contributions when made, or to defer taxation until vested, when they are taxed under 403(b).
- A provision that an employer may not condition any other employee benefits (except matching contributions) on an employee's election to defer into the 403(b) program.

WHAT TO DO? These are important changes and require action. If you maintain a 403(b) program, please contact us. Until now, some clients have been able to maintain programs with stock vendor documents. In some cases, we have helped you write agreements with your vendors regarding responsibility for various plan operations. In all cases, we should discuss your 403(b) operations and possible need for changes and documentation.

17. 457 PLANS

Recent legislation, including EGTRRA, and the new Section 457 final regulations, have made changes to the requirements under Section 457 for eligible State or local government employer defined contribution governmental plans. These plans must be amended to comply with the changes to the requirements under Section 457, including increases in elective deferral limits, repeal of rules coordinating the Section 457 plan limits with contributions to certain other types of plans, catch-up contributions for individuals age 50 and over, extension of qualified domestic relations order rules to 457 plans, rollovers to and from various types of eligible retirement plans, Section 403(b) contracts and IRAs. Such amendments must be adopted by December 31, 2005. The IRS has issued model amendments that may be used for these purposes. The amendments may include optional features, such as in-service distributions from rollover accounts, distributions for unforeseeable emergencies, loans, plan to plan transfers, and distributions of smaller accounts to eligible participants.

WHAT TO DO? If you maintain one of the described 457 plans, please contact us promptly so that we may keep you in compliance.

CLOSELY-HELD BUSINESSES

18. PERSONAL SERVICE CORPORATIONS

A professional corporation ("PC") that is taxed under Subchapter C of the Internal Revenue Code ("C corporation") is permitted to deduct expenses incurred by the business, including "salaries or other compensation for personal services actually rendered" by the professional corporations' owners. However, payments must be "reasonable" and compensate the owner for personally performed services. Compensation exceeding the reasonable value of a professional's personally performed services falls outside this provision and thus is not deductible.

Traditionally, a PC which is taxed as a C corporation endeavors to have no taxable income. This is often accomplished by paying enough compensation to the shareholders so that the PC has little or no taxable income, often in the form of year-end bonuses. However, the part of compensation paid to a shareholder which the IRS can prove is not reasonable is treated as a dividend paid on the shareholder's stock. A dividend is not deductible by the corporation.

A PC's shareholder compensation arrangement is likely to be scrutinized during an IRS audit. A bonus arrangement is problematic, particularly if it involves a division of profit made by the PC on work performed by non-shareholder employees who perform professional services. The IRS may argue that such compensation is not paid "purely for services actually rendered" by the recipients of the compensation. If not deductible as compensation, it is treated as a dividend, subject to both corporate and personal income tax.

PCs can avoid the entire controversy by converting to an S corporation or a limited liability company, either of which is a "pass through" entity for tax purposes. That is, the business is no longer a separate taxpayer. Rather, any profit or loss recognized by the entity flows through to the personal tax returns of its owners. Of course, a transition to this kind of entity could be very disruptive, and may not be consistent with business or other tax objectives.

PCs can also try to avoid dividend taxation by adopting compensation arrangements which are crafted with this reasonable compensation issue in mind. For example, shareholders might be compensated for management and other duties. It is helpful to document the work performed for the PC in addition to professional services. The argument is that the shareholder should be compensated both for his or her professional services and for operating the business. Furthermore, shareholders' bonuses might be based on productivity in order to attribute the division and payment funds to personally performed services. A PC should avoid pure equal-shares method for dividing bonuses among physician owners.

WHAT TO DO? If you are a PC, please contact us to formulate a strategy for dealing with the risk of dividend taxation.