August 21, 1998

MEMORANDUM

Employee Benefit Provisions of the IRS Restructuring and Reform Act of 1998 and the Transportation Equity Act for the 21st Century

The recently-enacted Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA") and Transportation Equity Act for the 21st Century ("TEA") include a number of provisions that affect employee benefit plans. This memorandum summarizes the more significant employee benefit provisions of these statutes.

1. CHANGE IN CAPITAL GAIN HOLDING PERIOD (*RRA* §§ *5001, 6005(d)).* The Taxpayer Relief Act of 1997 ("TRA '97") established new tax rates for capital gain. The RRA eliminates the 28% mid-term rate for property held between 12 and 18 months. Effective January 1, 1998, capital gain realized on the sale of property held for more than *one year* will be eligible for the 20% capital gain rate.

TRA '97 Rates	
Holding Period	**Maximum Tax Rate**
1 year or less	39.6%
12-18 months	28.0%
more than 18 mos.	20.0%
more than 5 years	18.0%

New RRA Rates	
Holding Period	**Maximum Tax Rate**
1 year or less	39.6%
more than 1 year	20.0%
more than 5 years	18.0%

Implications: The new rule affects stock option and stock purchase plans, restricted stock, ESOPs, section 401(k) plans, and other plans that provide compensation in the form of employer stock. Under the new rule, current and former employees who receive employer stock will have less incentive to hold the stock beyond one year. The new rule is likely to require revisions to prospectuses, summary plan descriptions, and other disclosure documents that include a description of the capital gain rates.

As in the past, when an employee receives employer stock as part of a lump-sum distribution from a qualified retirement plan, any appreciation in the stock's value from the date the plan acquired it to the distribution date is treated as "net unrealized appreciation." When the employee sells the stock, the net unrealized appreciation is automatically taxed at the 20% rate, regardless of how long the employee (or the plan) held the stock.

2. NONQUALIFIED DEFERRED COMPENSATION *(RRA § 7001).* The RRA changes the rules governing the timing of deductions for nonqualified deferred compensation. In general, under prior law, an employer could deduct compensation in the year the employee earned it if the compensation was paid to the employee no later than 2½ months after the end of the year. If compensation was deferred more than 2½ months after the year it was earned, the employer could deduct the deferred compensation in the year it was *includable in the employee's gross income*, even if the employee did not actually receive the compensation in that year.

For taxable years ending after July 22, 1998, the RRA provides that an employer may deduct nonqualified deferred compensation only in the year in which it is *actually received by the employee*, rather than in the year in which it is included in the employee's gross income.

The RRA also modifies the application of the 2½-month rule for determining whether a payment constitutes "deferred compensation." The RRA Conference Report indicates that Congress intends to treat an arrangement as providing deferred compensation unless the employee *actually receives* the compensation within the 2½-month period. Congress's stated objective is to prohibit the result in *Schmidt Baking Co. v. Commissioner*, which allowed an employer to deduct in 1991 benefits secured by an irrevocable letter of credit that the employer purchased within 2½ months after the end of the 1991 taxable year, even though the employees actually received the secured benefits after the 2½-month period.

Implications: The amendment makes it advisable to re-evaluate the income tax consequences of existing nonqualified deferred compensation arrangements and short-term deferral arrangements. Employers claiming a deduction in an earlier year for compensation or benefits provided at the beginning of the following year will need to determine whether the amendment delays the deduction.

The amendment adversely affects funded and secured deferred compensation arrangements. For example, if an employer contributes funds to an employee's account in a secular trust in the year 2000, but the funds are not actually paid to the employee until 2005, the employer may not deduct the contribution before 2005, even if the employee is required to include the value of the contribution in gross income in 2000.

The amendment gives Internal Revenue Service auditors greater incentive to apply the constructive receipt doctrine to unfunded deferred compensation arrangements. Under prior law, if an Internal Revenue Service agent applied the constructive receipt doctrine to accelerate an employee's recognition of income, the resulting tax revenue often was partly or entirely offset by the corresponding acceleration of the employer's deduction. Under the RRA, however, accelerating the employee's recognition of income under the constructive receipt doctrine will not accelerate the employer's deduction.

3. HARDSHIP WITHDRAWALS (*RRA* § *6005(c))*. Effective January 1, 1999, hardship withdrawals of § 401(k) funds will no longer be considered "eligible rollover distributions." This means that hardship withdrawals from § 401(k) accounts cannot be rolled over to another qualified plan or an IRA. In addition, § 401(k) hardship withdrawals will not be subject to mandatory 20% withholding. The recipient must include the hardship withdrawal in income when he receives it, but he may elect to have less (or more) than 20% of the distribution withheld. The same rule applies to hardship withdrawals from § 403(b) plans.

Implications: The amendment does not apply to hardship withdrawals derived from sources other than employees' elective contributions. Hardship withdrawals of profit-sharing or employer matching contributions still qualify as "eligible rollover distributions." As a result, if an employee makes a hardship withdrawal of both § 401(k) and matching funds, for example, the two portions of the withdrawal will have different tax consequences. This will impose significant administrative burdens on plan recordkeepers, administrators, and withholding agents who must separately account for each portion of the withdrawal, inform employees of the different tax consequences, and apply the correct withholding rules.

If a plan defines what is (or what is not) an "eligible rollover distribution," it might be necessary to revise the definition to reflect the new law. In addition, administrators should review summary plan descriptions and other disclosure documents, including the IRS model tax disclosure (the "§ 402(f) notice"), to determine whether changes are needed to reflect the new provision. Section 403(b) plan documents, annuity contracts, and disclosure materials should likewise be reviewed and modified where necessary.

4. MEALS FURNISHED TO EMPLOYEES *(RRA § 5002)*. The RRA expands the deduction (by an employer) and exclusion (by an employee) for meals provided to employees on the employer's premises.

Under prior law, if *substantially all* of the meals provided on the employer's premises were provided for the convenience of the employer, employees could exclude the cost of the on-site meals from gross income (even in cases where particular meals were not provided for the employer's convenience). Effective for taxable years beginning before, on, or after the RRA's enactment, if *more than half* of the employees who receive on-site meals are furnished those meals for the employer's convenience, all on-site meals are deemed to be for the convenience of the employer and are excludable from the employees' gross income.

In general, only 50 percent of any business meal expense is allowed as a deduction. This deduction limit does not apply to meals that are de minimis fringe benefits, including meals provided in company eating facilities where revenues equal or exceed operating costs. The Tax Court has held that the deduction limit also does not apply to on-site meals where substantially all of the meals are provided for the employer's convenience.

The RRA Conference Report confirms that meals provided for the convenience of the employer (as determined under the new "more than half" test described above) are fully deductible. The Conference Report states that no inference is intended as to whether such meals were deductible under prior law. The deduction, which is not reflected in the RRA itself, apparently arises as a result of the interaction between the new exclusion rule and the existing de minimis fringe benefit rules. Under the fringe benefit rules, an employee who receives an on-site meal for the employer's convenience is deemed to have paid the operating cost attributable to the meal. Accordingly, if all on-site meals are excludable under the new "more than half" test, the company eating facility will automatically satisfy the operating-cost requirement in the fringe benefit rules (since the cost of all on-site meals will be deemed paid by the employees).

Implications: Employers that provide, or that are considering providing, meals to their employees should take into account the effect of the RRA on the tax consequences of employer-provided meals.

5. PENALTY TAX FOR DISTRIBUTION PURSUANT TO IRS LEVY *(RRA § 3436)*. The RRA provides that if a taxpayer is deemed to receive a distribution from a qualified plan or IRA as the result of a federal tax levy, the distribution is not subject to the 10% penalty tax on early withdrawals. (The Tax Court had adopted this position in *Larotonda v. Commissioner*, but the Internal Revenue Service refused to acquiesce in the decision.)

Implications: Employers might need to revise summary plan descriptions and other disclosure documents that list circumstances in which the early withdrawal penalty applies.

6. IRAS, SIMPLE PLANS, AND ADOPTION CREDITS *(RRA §§ 6004(d), 6005(a), 6005(b), 6010(p), 6016(a), 6018(f), 7004)*. The RRA includes several provisions pertaining to Roth, education, and regular IRAs; SIMPLE plans; and the tax credit for adoption assistance. Please let us know if you would like more information about these provisions.

7. ELECTION BETWEEN CASH COMPENSATION AND TAX-FREE TRANSIT BENEFITS *(TEA § 9010).* TRA '97 included a provision allowing employers to offer employees a choice between employer-provided parking and additional cash compensation, without making the employer-provided parking a taxable benefit. In an apparent effort to put commuting by public transportation on an equal footing with commuting by car, the TEA takes this rule a step farther by permitting employers to offer employees a choice between cash compensation and any "qualified transportation fringe," without making the qualified transportation fringe a taxable benefit. "Qualified transportation fringes" include transit passes and vanpools, as well as parking facilities. The new provision is effective for taxable years beginning on or after January 1, 1998.

The TEA also increases the dollar limits on the amounts that can be excluded from income for transit passes and vanpools. Under prior law, the maximum dollar amount that could be excluded from gross income was $60 per month, indexed for inflation ($65 in 1998). Under the TEA, starting with taxable years beginning on or after January 1, 2002, the dollar limit for transit passes and vanpooling will be $100 per month, indexed for inflation.

Implications: Employers might wish to re-evaluate the transportation benefits they provide to their employees. The TEA provision permits employers to offer employees the choice of paying commuting expenses tax-free on a salary reduction basis.

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