Fiduciary Provided Investment Advice

Under prior law, the Department of Labor restricted a plan fiduciary "and certain other parties in interest" from providing investment advice to a participant. The restrictions were intended to prevent any inherent conflict of interest from impacting the investment advice provided to a participant. Unfortunately, these restrictions also left many participants without adequate guidance on how to invest their participant-directed accounts.

The Pension Protection Act of 2006, in Section 601, provides a new category of prohibited transaction exemption under ERISA and the Code, in connection with the provision of investment advice under an eligible advice arrangement to participants and beneficiaries in a defined contribution plan who direct the investment of their accounts under the plan. The new rules apply after 2006.

If the requirements under Section 601 are met, then the provision of investment advice, engaging in an investment transaction (sale, acquisition or holding of a security or other property) pursuant to the advice, and the direct or indirect receipt of fees or other compensation in connection with providing the advice or an investment transaction pursuant to the advice, are exempt from the prohibited transaction restrictions.

The prohibited transaction exemption provided under Section 601 is not intended to alter existing individual class exemptions provided by statute or administrative action.

Generally, the exemption provided under Section 601 applies in connection with the provision of investment advice by a fiduciary adviser under an eligible investment advice arrangement.

An eligible investment advice arrangement is an arrangement which either (i) provides that any fees received by the fiduciary adviser for investment advice or with respect to an investment transaction with respect to plan assets do not vary depending on the basis of any investment option selected, or (ii) uses a computer model under an investment advice program in connection with the provision of investment advice to a participant or beneficiary that meets certain requirements which are discussed below.

An eligible investment advice arrangement with respect to a defined contribution plan must be expressly authorized by the plan fiduciary other than the person offering the investment advice, any person providing investment options under the plan or any affiliate of these persons.

Where the investment eligible advice arrangement provides investment advice through a computer model, the model must (i) apply generally accepted investment theories that take into account the historic returns of different asset classifications over defined periods of time, (ii) use relevant information about the participant or beneficiary, (iii) use prescribed objective criteria to provide asset allocation portfolios comprised of investment options under the plan, (iv) operate in a manner that is not biased in favor of any investment options offered by the fiduciary adviser or related person, and (v) take into account all the investment options under the plan, specifying how a participant's or beneficiary's account should be administered without inappropriate weighting of any investment option.

About our Tax Practice Group

Our tax attorneys are proficient in helping businesses and individuals minimize their risk from a tax standpoint and maximize their business and financial goals. We have a broad depth of knowledge and expertise, allowing us to handle virtually all aspects of federal tax planning and even the most complex tax issues.

We are skillful in counseling clients as to the tax ramifications of all types of corporate transactions, including mergers and acquisitions, recapitalizations, spin-offs, reorganizations, equipment leasing, debt securitization and joint ventures. We are adept at identifying the tax issues, and assisting clients in identifying and formulating the tax strategies necessary to further their business objectives. Our tax attorneys also counsel clients on the tax implications of real estate transactions. Working in conjunction with our attorneys in our Real Estate Practice Group, we advise clients as to the proper vehicle for owning property and how to structure the real estate transaction to best minimize the tax consequences, including utilizing limited liability companies and grantor trusts.

If a computer model is used, the only investment advice that may be provided under the arrangement is advice generated by the computer model itself and any investment transaction pursuant to the advice must occur solely at the direction of the plan participant or beneficiary.

An annual audit of the eligible investment advice arrangement, for compliance with applicable requirements, must be conducted by an independent auditor. The auditor is required to issue a report of the audit results to the fiduciary that authorized use of the arrangement.

For purposes of Section 601, a "fiduciary adviser" is a person who is a fiduciary of the plan by reason of the provision of investment advice to a participant or beneficiary and who is also (i) registered as an investment adviser, (ii) a bank, a similar financial institution supervised by the United States or a savings association, but only if the advice is provided through a trust department that is subject to periodic examination, (iii) an insurance company qualified to do business under state law, (iv) registered as a broker or dealer under the Securities Exchange Act of 1934, (v) an affiliate of any of the preceding, or (vi) an employee, agent or registered representative of any of the preceding who satisfies the requirements of applicable insurance, banking, and securities laws relating to the provision of the advice.

Guidance on Reporting and Wage Withholding Under Section 409A

The American Jobs Creation Act of 2004 added Code Section 409A, which provides, *inter alia*, that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. On November 30, 2006, the Internal Revenue Service issued Notice 2006-100, 51 IRB 1109 (2006) to provide guidance to employers and payers on their reporting and wage withholding requirements for calendar years 2005 and 2006 with respect to deferrals of compensation and amounts includible in gross income because of a failure to satisfy the Section 409A requirements. Notice 2006-100 also provides guidance to service providers (employees and independent contractors) on their income tax reporting and tax payment requirements with respect to amounts includible in gross income under Section 409A for 2005 and 2006.

Detailed guidance is provided on the completion of the Form W-2 Wage and Tax Statement, Form 941 Employer's Quarterly Federal Tax Return, and Form 1099-MISC Miscellaneous Income, for deferred compensation subject to Section 409A.

For account balance plans, as defined in Treas. Reg. § 31.3121, the amount deferred as of December 31, 2006 equals the amount that would be treated as an amount deferred under said regulation on December 31, 2006, if the entire account balance (including all principal amounts, adjusted for income, gain or loss credited to the service provider's account) as of December 31, 2006 were treated as a principal amount credited to the service provider's account on December 31, 2006.

For nonaccount balance plans, as defined in Treas. Reg. § 31.3121, where the amount deferred is reasonably ascertainable within the meaning of said regulation, the amount deferred as of December 31, 2006 equals the present value of all future payments to which the service provider has obtained a legally binding right as of December 31, 2006, calculated in accordance with said regulation as if the service provider had obtained all of such rights on December 31, 2006.

For a stock right covered by Section 409A, the amount deferred as of December 31, 2006 equals the amount that the service provider would be required to include in income if the stock right were immediately exercisable and exercised on December 31, 2006 (i.e., generally, the fair market value of the underlying stock less the sum of the exercise price). For all deferred amounts not addressed above, the amount deferred as of December 31, 2006 must be determined under a reasonable, good faith application of a reasonable, good faith method.

As to 2005 amounts includible in gross income under Section 409A, employers and payers, including employers and payers who relied on Notice 2005-94 for calendar year 2005, who suspended employers' and payers' reporting requirements with respect to deferrals of compensation includible in gross income under Section 409A, are required to file an original or a corrected information return and furnish an original or a corrected payee statement (Form W-2 or 1099-MISC) for calendar year 2005 reporting any previously unreported amounts includible in gross income under Section 409A for calendar year 2005 as determined under guidance provided by Notice 2006-100 for calendar year 2006. The original or corrected information return and the original or corrected payee statement for calendar year 2005 must be filed and furnished by the deadlines applicable for filing an information return and furnishing a payee statement reporting amounts includible in income in calendar year 2006. (Generally, this means the original or corrected information return must be filed by February 28, 2007, and the original or corrected payee statement must be furnished by January 31, 2007.)

A service provider must report as income and pay any taxes due relating to amounts includible in gross income under Section 409A for calendar year 2006. In addition, if a service provider has not reported as income and paid any tax due relating to amounts includible in gross income under Section 409A for calendar year 2005, calculated in accordance with Notice 2006-100, the service provider must file an amended 2005 return and pay any taxes due relating to such amounts. If the service provider is required to file an amended 2005 return in order to report amounts includible in

income under Section 409A, the service provider must file such amended return and pay any additional taxes owing by the due date for the service provider's 2006 income tax return, including extensions, in order to avoid penalties.

If compensation is required to be included in gross income under Section 409A, the tax imposed on such income is increased by the sum of two additional taxes equal to the amount of interest determined under Section 409A plus an amount equal to 20% of the compensation which is required to be included in gross income. The amount of interest is the amount of interest at the underpayment rate plus one percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.

Default Investment Elections

Under Section 404(c) of ERISA, if certain requirements are satisfied, an employer or other plan fiduciary is not liable for "bad investments" if a participant is able to direct his or her own plan investments. A plan fiduciary remains potentially liable for placing a "bad investment" on the plan's investment menu or failing to monitor plan investments and removing the "bad investments." Prior to the Pension Protection Act of 2006, the Department of Labor had ruled that an employer, or other plan fiduciary, is not protected under Section 404(c) unless the participant exercises affirmative investment control over his or her own accounts. In other words, if a participant failed to complete an investment election, and his or her benefits were invested by "default" the employer or other fiduciary was not protected from liability, if "issues" later arose with the default investment.

The lack of protection afforded to default investments caused many employers to select an "ultra safe" default investment, such as a stable value fund or money market type account. However, this selection deprived a participant of the potentially higher rate of return provided by riskier options.

Under the PPA, protection will be provided to a plan fiduciary under Section 404(c) if the default investment includes a mix of asset classes consistent with capital preservation, long-term capital appreciation or a blend of both. A default arrangement applies until a participant exercises control. Notice of a participant's right to exercise control and the administrator's obligations must be provided. The new rules apply for plan years beginning after 2006.

The Department of Labor issued Proposed Regulations Section 2550.404c-5 regarding relief for investment in qualified default investment alternatives on September 26, 2006.

Under the proposal, a fiduciary of an individual account plan that permits participants or beneficiaries to direct the investment of assets in their accounts, shall not be liable for any loss or by reason of any breach of Part 4 of Title I of ERISA that is the direct and necessary result of (i) investing all or part of a participant's or beneficiary's account in a qualified default investment alternative or (ii) investment decisions made by an investment manager in connection with the management of a qualified default investment alternative.

A fiduciary is not relieved from its duties to prudently select and monitor any qualified default investment alternative or from any liability that results from a failure to satisfy its duties, including liability for any resulting losses.

For the relief to apply, (i) assets must be invested in a "qualified default investment alternative", (ii) the participant or beneficiary on whose behalf the investment is made must have had the opportunity to direct the investment of the assets in his or her account, but did not direct the investments of the assets, and (iii) the participant or beneficiary on whose behalf an investment in a qualified default investment alternative may be made is furnished within a reasonable period of time of at least thirty days in advance of the first such investment, and within a reasonable period of time of at least thirty days in advance of each subsequent plan year, a summary plan description, summary of material modification or other notice that meets certain disclosure requirements. Moreover, under the terms of the plan, any material provided to the plan relating to a participant's or beneficiary's investment in a qualified default investment alternative will be provided to the participant or beneficiary, and any participant or beneficiary on whose behalf assets are invested in a qualified default investment alternative may consistent with plan terms (but in no event less frequently than once within any three month period), transfer in whole or in part, such assets to any other investment alternative available under the plan without financial penalty.

To constitute a qualified default investment alternative, the alternative:

(i) must not hold or permit the acquisition of employer securities except as discussed below;
(ii) must not impose financial penalties or otherwise restrict the ability of a participant or beneficiary to transfer in whole or in part his or her investment from the qualified default investment to any other investment alternative available under the plan;
(iii) must be managed by an investment manager or an investment company registered under the Investment Company Act of 1940;
(iv) must be diversified so as to minimize the risk of large losses; and
(v) consist of one of the following:
    (a) an investment fund or product or model portfolio

that is designed to provide varying degrees of long-term appreciation and capital preservation for a mix of equity and fixed income exposures based on the participant's age, target retirement date or life expectancy;

(b) an investment fund product or model portfolio that is designed to provide long-term appreciation and capital preservation for a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole; or

(c) an investment management service with respect to which an investment manager allocates the assets of a participant's individual account to achieve varying degrees of long term appreciation and capital preservation through a mix of equity and fixed income exposures offered through investment alternatives available under the plan based on the participant's age, target retirement date and life expectancy.

The restriction in holding employer securities is not applicable where the employer's securities are held or acquired by an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle; where the employer securities are part of a qualified investment alternative which encompasses an investment management service where the securities are acquired as a matching contribution from the employer or acquired prior to management by the investment management service; and where a holding of employer securities does not impose financial penalties or otherwise restrict the ability of a participant or beneficiary to transfer in whole or in part his or her investment from the qualified default investment alternative to any other available plan investment alternative.

An employer notice used in place of the summary plan description or summary of material modification must contain:

(i) A description of the circumstances under which assets in the individual account of a participant or beneficiary may be invested on behalf of the participant and beneficiary in a qualified default investment alternative;

(ii) A description of the qualified default investment alternative, including a description of the investment objectives, risk and return characteristics and fees and expenses attendant to the investment alternative;

(iii) A description of the right of the participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative to direct the investment of those assets to any other plan investment alternative without financial penalty; and

(iv) An explanation of where the participants and beneficiaries can obtain investment information concerning other investment alternatives available under the plan.

Settlement Annuities Includible in Gross Estate and Funeral Luncheon Costs Not Deductible as Funeral Expenses

The value of two annuities received by a decedent-child pursuant to a settlement agreement are includible in a decedent's estate at the Section 7520 rate when the decedent has a beneficial interest in the annuities at her death. *Davenport Est. v. Comm.,* T.C. Memo 2006-215 (Oct. 5, 2006). Additionally, a decedent is not allowed to deduct funeral luncheon costs as a funeral expense if a Court cannot ascertain if the costs are reasonable.

In *Davenport*, the decedent was a 12 year old child who was born suffering from numerous ailments, including cerebral palsy and mental retardation. A malpractice lawsuit was filed against the obstetrician and hospital alleging that their actions caused the decedent-child to suffer such ailments and the parents to suffer personal injuries. The parties subsequently settled the lawsuit pursuant to a settlement agreement. The agreement provided for a lump-sum payment by the obstetrician to the parents, and for the payment of two annuities by the hospital payable to the parents as co-conservators of the decedent-child. The annuities provided for monthly payments of $2,500, beginning November 15, 1991, for the decedent-child's life, compounded annually at 5%, and guaranteed for 30 years. Any payments to be made after the decedent-child's death were to be made payable to the beneficiary designated by the decedent-child or her parents. If no beneficiary was named, then any payments would be made to the decedent-child's estate. The agreement permitted the hospital to satisfy its annuity obligation by purchasing annuity policies from two commercial annuity companies. Annuities were subsequently purchased by the hospital to satisfy the agreement. The beneficiary of both policies upon the decedent-child's death was the child's estate.

The decedent-child passed away on October 31, 2000. A probate estate was opened and a Federal estate tax return was filed for the decedent-child, which showed the value of the annuities as zero and claimed funeral expense deductions for funeral luncheon costs. The estate contended that the remaining annuity payments were payable to trusts created by the parents. Upon audit of the return, the Internal Revenue Service requested and obtained a copy of the probate estate's inventory. The inventory showed the annuities valued at $1,118,000. Revised inventories which excluded the annuity values were subsequently sent to the Internal Revenue Service. On June 10, 2004, the Internal Revenue Service issued a deficiency stating that the gross estate should have included the value of the annuities and should have excluded the funeral luncheon costs.

The Annuities

In *Davenport*, the Court found that the annuities were includible in the child's estate for estate tax purposes since the child held a

beneficial interest in the annuities at her death. Section 2033 states that an estate for estate tax purposes includes the value of all property in which and to the extent a decedent has an interest. Section 2039 further generally provides that a decedent's estate includes the value of any annuity or other payment receivable by a beneficiary by reason of surviving the decedent if the annuity was payable to the decedent, or the decedent possessed the right to receive the annuity, for his life or for any period not ascertainable without reference to his death, or for any period which does not end before his death. Section 2033 has previously been construed to include the value of annuities payable to a decedent's estate upon his or her death. The parties agreed and case law supports that the language of the settlement agreement (and not the annuity contract language) controls in determining if the annuity contracts are includible in the decedent-child's estate under Section 2033.

Although the estate argued in *Davenport* that the estate should not include the full value of the annuities since the parents jointly held the beneficial interests in the annuities with the decedent-child, the annuity payments were made to satisfy both the parents and the decedent-child's claims against the defendants, and the annuities were payable to trusts created by the parents, the Court found that the decedent-child was the sole beneficiary of the annuities and the full value of the annuities should consequently be includible in the decedent-child's estate for estate tax purposes. In reaching this result, the Court found no evidence, such as a change of beneficiary form, to show that the beneficiary of the annuities was the trusts. Additionally, the Court found it persuasive that the settlement agreement was entered into to redress some of the injuries sustained by the decedent-child which were specifically referenced to in the lawsuit, the decedent-child was named as payee of the annuities, the decedent-child was the measuring life of both annuities, and the benefit checks were made payable to the decedent-child though her parents as co-conservators. The Court also found it persuasive that the settlement agreement explicitly stated that the parents were the payees of the lump-sum amount and the decedent-child was the sole payee of the annuities. Additionally, the initial inventory filed in the decedent-child's probate estate included the full value of the annuities and a corresponding inventory fee was paid based upon inclusion of such value. No evidence was presented which showed that a refund of a portion of that fee was obtained. Instead, the full inventory fee was claimed as an administration expense on the decedent-child's estate tax return. To counter these points, the estate merely presented testimony by the decedent-child's parents that the annuities were meant to be held jointly held by the decedent-child and the parents, which the Court found unpersuasive.

The Court also could not ascertain if the parties to the lawsuit intended that the annuities were to be in settlement of both the parents and decedent-child's claims since the estate did not depose the defendants. If a settlement agreement fails to designate the reason for the payment, then the intent of the payor controls for tax purposes. In this case, the estate did not take any depositions to ascertain the defendant's intent when preparing the settlement agreement.

Since the annuities were includible in the decedent-child's estate under Section 2033, the Court did not determine if the annuities would also be includible under Section 2039.

After determining that the annuities were includible in the decedent-child's estate, the Court ruled that the annuities were valued at their fair market value according to Section 7520 and Treas. Reg. §20.2031-7. According to Section 7520 and Treas. Reg. §20.2031-1(b), the value of property includible in a decedent's estate under Section 2033 is its fair market value at the time of the decedent's death. Treas. Section 7520 further provides actuarial tables to value annuities. Treas. Reg. §20.2031-7 provides how to value annuities. Annuities issued by companies regularly engaged in the sale of such products are valued according to Treas. Reg. §20.2031-8. The Court found that the decedent-child's annuities were properly valued under Treas. Regs. §20.2031-7 and 8 since the settlement agreement provided that the hospital, and not a commercial annuity provider, was to provide the annuity payments. As a result, the Court found that annuities should be valued at the Section 7520 rate in accordance with Treas. Reg. §20.2031-7.

The Funeral Luncheon

Funeral luncheon costs were disallowed as a funeral expense in *Davenport* since the Court was unable to determine if the costs were reasonable. According to Section 2053(a)(1), an estate may deduct funeral expenses that are deductible according to the laws of the jurisdiction under which it is being administered. In *Davenport*, Michigan law controlled the administration of the estate. Under law, reasonable funeral and burial expenses are deductible. Examples of deductible costs include reasonable expenses for a tombstone, monument, mausoleum, or burial lot, reasonable costs for its future care, and costs for transportation of the person bringing the body to the place of burial. See, Treas. Regs. §20.2053-2. The basis for the deduction is the necessity of the expense in connection with the decedent's funeral. Funeral expenses means expenses incurred in connection with the decedent's estate.

In *Davenport*, the court found no basis to support whether the claimed funeral luncheon expense was reasonable. Instead, the estate merely presented testimony from the decedent-child's parents that the purpose of the reception was to thank family, teachers and other healthcare professionals who worked with the decedent-child over the years, and that the luncheon was held in a larger venue to handle the volume of people who attended the

funeral. In ruling that the funeral luncheon costs were not deductible, the Court stated that in order to determine if the luncheon costs were reasonable, the Court needed to know the components of the cost and their respective costs (i.e. venue, decorating, catering, entertainment, supplies and service costs). Also, the Court noted that the testimony inferred that the luncheon was to recognize and thank third parties, and not the traditional focus of a funeral in eulogizing and laying to rest the deceased. The Court further stated that it was unclear whether the people who attended the luncheon also attended the funeral. Consequently, the Court disallowed the funeral luncheon costs since it was unable to determine if the costs were reasonable and were incurred in connection with the decedent-child's funeral.

Diversifying Defined Contribution Plan Assets

Under Section 401(a)(35) as added by the Pension Protection Act of 2006, in order to satisfy the plan qualification requirements of ERISA, certain defined contribution plans are required to permit applicable individuals to direct that the portion of the investment of the individual's account held in employer securities be invested in alternative investments. An applicable individual includes any plan participant, and any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise a participant's rights. Plans subject to these new requirements include defined contribution plans holding publicly traded employer securities. Here, a plan holding employer securities that are not publicly traded is generally treated as holding publicly traded employer securities if the employer, or any member of the employer's controlled group of corporations, has issued a class of stock that is a publicly traded employer security.

The new diversification requirements do not apply to ESOPs that do not hold contributions, or earnings, that are subject to the special non-discrimination tests that apply to elective deferrals, employee after-tax contributions and matching contributions and are separate from any other qualified retirement plan of the employer. The new requirements also do not apply to a one participant retirement plan.

In the case of amounts attributable to elective deferrals under a qualified cash or deferred arrangement, and employee after-tax contributions, that are invested in employer securities, any applicable individual must be permitted to direct that such amounts be invested in an alternative investment. Where the amounts are attributable to contributions other than elective deferrals and after-tax employee contributions that are invested in employer securities, an applicable individual is a participant with three years of service or a beneficiary of such a participant. Each has to be able to direct that such employer security investments be invested in alternative investments.

While the new rules are effective in 2007, a transition rule applies to amounts attributable to contributions that are invested in employer securities acquired before 2007. Here the diversification rights would apply only to the applicable percentage of the number of shares of such securities. The applicable percentage is 33% for the first plan year to which diversification rules apply, 66% for the second plan year and 100% for all subsequent years. This transition rule does not apply however to a participant who before the first plan year beginning after 2005 had attained age 55 and completed at least three years of service.

A special effective date rule applies with respect to employer matching and non-elective contributions that are invested in employer securities that as of September 17, 2003 consisted of preferred stock held within an ESOP where the value of the preferred stock is subject to a guaranteed minimum.

Plans subject to the new diversification requirement must give applicable individuals a choice of at least three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics. A plan will not be deemed to have failed to meet the diversification requirements just because the plan limits the times when divestment and reinvestment can take place to periodic, reasonable opportunities that occur at least quarterly. It is intended that applicable individuals be given the opportunity to make investment changes with respect to employer securities on the same basis as the opportunity to make other investment changes. Except as provided in the Regulations, a plan may not impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other plan assets (other than restrictions or conditions imposed by reason of applicable securities law).

The Internal Revenue Service issued additional guidance on Section 401(a)(35) in Internal Revenue Service Notice 2006-107, 51 IRB 1114 (2006). The Service held that a plan is not treated as holding employer securities to which the diversification rules are applicable with respect to any securities held by either an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle that is regulated and subject to periodic examination by a Federal or State agency and with respect to which investment in the securities is made both in accordance with the stated investment objectives of the investment vehicle and independent of the employer and any affiliate thereof, but only if the holdings of the investment company or similar investment vehicle are diversified so as to minimize the risk of large losses.

Insofar as applicable individuals are concerned, the diversification rights extend to any participant, any alternate payee who has an account under the plan and any beneficiary of a deceased participant.

Employee contributions, for diversification purposes, include both employee after-tax contributions and rollover contributions.

The diversification rights apply only when publicly traded employer securities are held under the plan and allocated to a participant's or beneficiary's account.

Investment alternatives must include not less than three choices, other than employer securities, to which the applicable individual may direct the proceeds of an employer securities divestment. Each investment option must be diversified and have materially different risk and return characteristics.

A plan is not treated as failing to meet the diversification requirements just because the plan limits the time for divestment and reinvestment to periodic reasonable opportunities occurring not less frequently than quarterly.

A plan is prohibited from imposing restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other plan assets. Examples of prohibited restrictions or conditions include a plan allowing applicable individuals the right to divest employer securities on a periodic basis, but permitting divesture of other investments on a more frequent basis and a plan under which a participant who divests his or her account of employer securities receives less favorable treatment, such as a lower rate of matching contributions, than a participant whose account remains invested in employer securities.

Restrictions or conditions that are not prohibited include a provision that limits the extent to which an individual's account balance can be invested in employer securities and a provision under which an employer securities investment fund is closed, i.e. other amounts invested under the plan cannot be transferred into an investment in employer securities.

Lastly, a restriction imposed by reason of applicable securities law or a restriction that is reasonably designed to insure compliance with such laws is not an impermissible restriction or condition for diversification purposes.

Under Section 101(m) of ERISA, plans are required to notify applicable individuals of their diversification rights. A model notice is contained in Internal Revenue Service Notice 2006-107.

Plan administrators must provide a notice to applicable individuals not later than 30 days before the first date on which individuals are eligible to exercise their rights. However, the Department of Labor has advised the Treasury that Section 101(m) does not require certain plans to furnish the notice before January 1, 2007. In Field Assistance Bulletin 2006-03 issued by the U.S. Department of Labor, the Director of Regulations and Interpretations indicated that for participants and beneficiaries that have been conferred new diversification rights as of January 1, that the notice should be furnished as quickly as possible following January 1. However, with regard to individual account plans that before 2007 provided participants and beneficiaries diversification rights at least equal to those conferred under the new rules, the Department will treat a plan administrator's compliance with the periodic benefit statement requirements for defined contribution plans under Section 105 of ERISA as satisfying the notice requirements of Section 101(m).

Harmonizing the Origin and Purpose of the Tax Reform Act of 1986

In *Estate of Gerson v. Comm.*, 127 T.C. No. 11 (Oct. 24, 2006) the Tax Court upheld the validity of Treas. Reg. §26.2601-1(b)(1)(i), and held that the exercise of a testamentary general power of appointment by a decedent in favor of her grandchildren was ineligible for transitional relief from the generation-skipping transfer tax (the "GST tax") under the Tax Reform Act of 1986 ("TRA").

Gerson, involved a marital trust that became irrevocable in 1973, upon the death of the settlor, Mr. Gerson. The trust conferred upon Mrs. Gerson a general power of appointment over the trust property. Mrs. Gerson died in 2000, and exercised her general power of appointment, through her will, in favor of her five grandchildren. As a result, the Internal Revenue Service issued a notice of deficiency to the Estate for GST tax.

Under Section 1433(a) of the TRA, the GST tax generally applies to all generation-skipping transfers made after October 22, 1986; however, this Section has provided certain exceptions to this general rule. One of these exceptions provides that the GST tax does not apply to any transfer from a trust that was irrevocable on September 25, 1985, to the extent that the transfer is not made from additions to the trust after September 25, 1985. As interpretive of this provision, the Treasury promulgated Treas. Reg. §26.2601-1(b)(1)(i), which provides that the grandfathering rule does not apply to a transfer of property pursuant to the exercise, release or lapse of a general power of appointment that is treated as a taxable transfer for gift or estate tax purposes. The regulation treats such a transfer as being made by the person holding the power at the time the exercise, release or lapse of the general power of appointment becomes effective, and is not considered a transfer under a trust that was irrevocable on September 25, 1985.

Pursuant to Treas. Reg. §26.2601-1(b)(1)(i), the Internal Revenue Service argued that the purpose of the transition rule is to protect only those taxpayers who were irrevocably committed to a generation-skipping transfer as of September 25, 1985; the relevant inquiry being whether the transfer was mandated under a trust that was irrevocable as of that date. The Internal Revenue Service reasoned that the disputed transfer was subject

to the GST tax because it was optional at Mrs. Gerson's election. The estate argued that Treas. Reg. §26.2601-1(b)(1)(i) was an invalid attempt by Treasury to rewrite Section 1433(b)(2) and to override the judicial construction of the statute's plain language, further asserting that the transfer was exempt from GST tax because it constituted a transfer "under a trust" that was irrevocable on September 25, 1985.

In *Peterson Marital Trust v. Comm.*, 78 F.3d 795(2d Cir. 1996) affg. 102 T.C. 790(1994) the Tax Court upheld a prior Regulation which established that the lapse of a general power of appointment would result in a constructive addition to a trust and that such a transfer was subject to GST tax. However, in *Simpson v. U.S*. 183 F.3d 812 (8th Cir. 1999) rev. and remanding 17 F. Supp. 2d 972 (W.D. Mo. 1998), the Eighth Circuit addressed a scenario nearly identical to the instant case and held that a transfer to grandchildren pursuant to the exercise of a general power of appointment was eligible for transitional relief from GST under Section 1433(b)(2)(A). Lastly, in *Bachler v. U.S*. 281 F.3d 1078 (9th Cir. 2002), rev. and remanding 126 F.Supp 2d 1279 (N.D. Cal. 2000), another case presenting the scenario nearly identical to this case the Court of Appeals, following *Simpson* held that the disputed transfer was eligible for relief from GST under Section 1433(b)(2)(A). Since the disputed transfer occurred in 1997, the Court declined to address the validity of Treas. Reg. § 26.2601-1(b)(1)(i).

The Tax Court looked at prevailing case law, legislative history and Treasury's general authority to promulgate interpretive regulations and ruled that Treas. Reg. §26.2601-1(b)(1)(i) was a valid interpretation of Section 1433(b)(2). Thus, because the property subject to the decedent's general power of appointment was deemed equivalent to an outright ownership by the power holder, the property was subject to GST tax.

If you have any questions regarding the foregoing, please contact a member of this Firm's Tax, Employee Benefits or Estate Planning Groups.

Bruce H. Balonick	(312) 876-7123
Ray H. Burgan	(312) 876-6669
Colleen E. Chinlund	(312) 876-7886
Robert T. Cichocki	(312) 876-6926
Lawrence E. Grelle	(847) 843-2900
Maureen B. Grzeskiewicz	(312) 876-6657
Robin King	(954) 713-7624
Douglas Kniskern	(954) 713-7625
Kathleen M. Lach	(312) 876-6660
Thomas F. McGuire	(312) 876-7195
Robert E. McKenzie	(312) 876-6927
Theresia Wolf-McKenzie	(312) 876-6659
A. Thomas Skallas	(312) 876-6682
Edward A. Snyder	(312) 876-7196
Jay P. Tarshis	(312) 876-7891
Robert I. Ury	(312) 876-7855
Michael J. Zdeb	(312) 876-6697

This newsletter provides information on current legal issues. However, that information should not be construed as legal advice or an opinion as to particular situations or applications.

ARNSTEIN & LEHR LLP

Chicago, Illinois
120 S. Riverside Plaza, Suite 1200
Chicago, IL 60606-3910
312.876.7100 phone
312.876.0288 fax

Hoffman Estates, Illinois
2800 W. Higgins Road, Suite 425
Hoffman Estates, IL 60169-5224
847.843.2900 phone
847.843.3355 fax

Boca Raton, Florida
2424 N. Federal Highway, Suite 462
Boca Raton, FL 33431
561.322.6900 phone
561.322.6940 fax

Fort Lauderdale, Florida
200 E. Las Olas Boulevard, Suite 1700
Fort Lauderdale, Florida 33301
954-713-7600 phone
954-713-7700 fax

Miami, Florida
200 S. Biscayne Blvd., Suite 3600
Miami, FL 33131
305.374.3330 phone
305.374.4744 fax

Tampa, Florida
Two Harbour Place
302 Knights Run Avenue, Suite 1100
Tampa, Florida 33602-3343
813.254.1400 phone
813.254.5324 fax

West Palm Beach, Florida
515 N. Flagler Drive, Suite 600
West Palm Beach, FL 33401-4323
561.833.9800 phone
561.655.5551 fax

Milwaukee, Wisconsin
7161 N. Port Washington Road
Milwaukee, WI 53217
414.351.2440 phone
414.352.6901 fax

www.arnstein.com

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