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SECTION OF TAXATION

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COMMITTEE ON EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS

INTERNAL REVENUE SERVICE

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The following questions and answers are based on an oral presentation made by IRS and Treasury officials at the Tax Section's Employee Benefits Committee meeting on May 6, 2011. The statements contained herein cannot be relied on even though they are printed as statements of the IRS. The questions were submitted by ABA members, and the responses were given at such meeting after explicit statements that their responses reflect the unofficial, individual views of the government participants as of the time of the discussion, and do not necessarily represent agency policy. This report on the responses was prepared by designated JCEB representatives, based on the notes and recollections of the JCEB representatives at the meeting and on a review of audio tapes of the meeting. This report has not been reviewed by IRS or Treasury. The questions were submitted in advance to the agency, and it was understood that this report would be made available to the public.

1. § 104, § 105, § 106 and § 132 – Wellness Programs

An employer maintains a group health plan. The employer selects Insurer A to provide the benefits under the group health plan. Insurer A's benefit design includes a wellness program. In part, the wellness program provides that if an employee exercises three times a week for a month at a health club, the employer's group health plan will pay $20 of an employee's health club membership for that month. Insurer A makes the payments to the health club (not the employer). Insurer A does not provide the employer with a list of the amounts paid on behalf of the employer's employees to health clubs. If an employee participates in the wellness program for an entire year, do the payments to the health club constitute income to the employee? If the payments are income, is there a *de minimis* amount that would not need to be reported (for example, if an employee participates in the wellness program for only one month and Insurer A pays only $20 of the employee's health club fees)?

Proposed Response: The health club payments are not income. They are part of the group health plan design and can be seen as a premium discount to the employees receiving the payments. If the health club payments are income, then there would be no *de minimis* exception because Insurer A is tracking the amount paid and the employees on behalf of whom the amounts are paid. *See* Treas. Reg. Section 1.132-6. If the health club payments are income, then the employer must report the amounts on an employee's Form W-2 as additional compensation.

IRS Response: If the amounts are paid on a pre-tax basis, then there is income. If the amounts are paid on a post-tax basis, then there is an argument that the amounts are not income. If the amounts are being paid on a pre-tax basis, then the employee is receiving a tax benefit through the payment of the club dues. To the extent the amounts are income, the payments are made in connection with the performance of services by an employee for an employer. Consequently, unless the amounts are otherwise excludible, the amounts are wages. The value of a fringe benefit that is unreasonable or administrative impracticable to account for may be excludible as a *de minimis* fringe benefit under Section 132(e) of the Code, but the provision of a cash fringe benefit is generally not excludible as a *de minimis* fringe benefit. Similarly, a cash equivalent fringe benefit, such as a gift certificate or the use of a credit card, is generally not excludible. It would not be unreasonable or administratively impracticable to account for the payments, regardless of the amount. The payments are included in the employee's gross income and wages. The Service representative noted that it was not completely clear whether the insurer is acting as an agent or as a Section 3401(d)(1) employer in this fact pattern. Whether the insurer is acting as an agent or a Section 3401(d)(1) employer determines who is responsible for the reporting, withholding and payment of the employment taxes. The Service representative indicated that the insurer appeared to be acting as an agent, so in this fact pattern, the common law employer would be responsible for the reporting, withholding and payment of employment taxes.

2. § 104, § 105, § 106 and § 132 – Wellness Programs

An employer sponsors a wellness program. As part of the wellness program, the employer provides rewards to employees who complete certain activities. The wellness program is not connected to the employer's group health plan – all employees are eligible to participate regardless of whether the employee is covered by the employer's group health plan. Employees who perform certain activities (including taking a health risk assessment; taking a biometric screening of blood pressure, cholesterol, and blood sugars; walking a certain number of miles each week; and going to a health club a certain number of times each month) earn points. For each 20 points earned, the employee receives a ticket and is entered into a drawing. At the end of each quarter, the employer draws tickets and awards prizes to the employees that range from a paid one-month membership in

a health club to an evening at a hotel. Every employee who earns a ticket receives a $25 gift card to a local store. Every employee who participates receives a T-shirt with the employer's logo. Are the prizes, gift cards, or T-shirts compensation that the employer must report on the employee's Form W-2 by the employer?

Proposed Response: The $25 gift cards given to employees are not a *de minimis* fringe benefit exempt under Section 132 because the employer knows each employee who receives a gift card and the amount. *See* Treas. Reg. § 1.132-6. Therefore, the employer is to include the amount in the compensation reported of employees who receive the gift cards. The T-shirts, in contrast, are a *de minimis* fringe benefit. *See* Priv. Ltr. Rul. 2010-05-014 (Oct. 28, 2009). The prizes are not a *de minimis* fringe benefit exempt under Section 132 because the employer knows each employee who receives a prize and if the employer purchased the prize the employer knows the cost of the prize. *See* Treas. Reg. § 1.132-6. If, however, a vendor gives the employer items that are awarded as prizes and does not charge the employer, then the prize is not compensation that must be included in an employee's income because of the difficulty in determining the value of the prize.

IRS Response: The analysis in this question is similar to the analysis in the prior question. If the employee receives cash or cash equivalents, which includes the $25 gift cards, it is not going to be an excludible fringe benefit. The t-shirts, however, are not cash equivalents and are unreasonable or administratively impracticable to account for. Consequently, the t-shirts are excludible from gross income and wages as *de minimis* fringe benefits. The prizes are valued at the fair market value of the prizes and are includible in gross income and wages.

3. § 106(f) and § 125 – Reimbursement of Prescriptions

An employer, which has employees in ten states including North Dakota, maintains a health flexible spending account plan. North Dakota state law defines a prescription as follows:

- The name and address of the patient
- The date of issuance
- The name of the drug
- The quantity
- The strength
- Adequate directions for use
- The prescriber's name (either printed or stamped)
- The prescriber's indication of refill authorization
- A reminder legend in a least six-point uppercase print stating, "In order to require that a brand name product be dispensed, the practitioner must hand write the words 'brand necessary'"
- The signature of the prescriber, unless it is an oral or telephoned prescription

See N.D. Admin. Code 61-14-06-02 (2010). An employee in North Dakota visits a doctor and the doctor prescribes for the employee regular, over-the-counter strength pain reliever (such as Advil) and regular, over-the-counter strength cold medication. The two prescriptions satisfy the definition of a prescription for purposes of North Dakota state law. Both prescriptions state the medications are to be taken as needed. May these two prescriptions be reimbursed under the health flexible spending account plan?

Proposed Response: Yes. Because a doctor prescribed these medications and the prescription satisfies the state law definition of what is a prescription, the pain reliever and cold medication may be reimbursed. *See* Code § 106(f) (added by Section 9003 of the Patient Protection and Affordable Care Act); Notice 2010-59, 2010-39 I.R.B. 396 (Sept. 27, 2010).

IRS Response: The Service representative agrees with the proposed response. Because a doctor prescribed these medications and the prescriptions satisfy the state law definition of a prescription, the prescriptions may be reimbursed.

4. § 223 – Health Savings Accounts

Section 223(d)(1)(E) of the Code provides that a health savings account ("HSA") must meet the requirement that "[t]he interest of an individual in the balance in his account is nonforfeitable" ("HSA Nonforfeitability Rule"). A bank serves as an HSA trustee or custodian.

The bank accepts electronic deposits through the automated clearing house ("ACH") network. The ACH network is a network of banks governed by NACHA – The Electronic Payments Association, which promulgates operating rules and guidelines for the ACH network.

Under the ACH system, a person wishing to deposit money into an HSA account at a bank (the "Receiving Bank") authorizes an originating bank (the "Originating Bank") to draw upon the person's account at another bank (the "Paying Bank"). Upon such a request, the Receiving Bank electronically credits the HSA account with the amount of the HSA contribution and the Paying Bank electronically debits the same amount from the person's account at Paying Bank. These electronic entries are required under the ACH rules, even though no money actually is deposited into the HSA account on the day the ACH request is made. The money is deposited into the person's account at the Receiving Bank on the date specified by the ACH entry. The HSA account holder can view the electronic credit to his or her HSA account by visiting the Receiving Bank's website. Thus, the HSA account holder could immediately believe that his or her HSA account contains the amount that is being transferred. The HSA account holder has immediate access to those funds.

In the days following the ACH entry completion, the person's account at the Paying Bank is verified in normal ACH processing to include but not limited to (a) whether the person's account is still open, (b) whether there are sufficient funds to complete the transaction ("cleared") and the amount of the HSA contribution is deducted from the person's account at the Paying Bank and deposited into the HSA at the Receiving Bank ("settlement"), (c) whether the owner of the account has withdrawn authorization for the funds to be removed from the account, (d) whether the account number is valid, (e) whether it is a non-transactional account, or (f) whether the Receiving Bank is qualified to participate in the ACH network (individually a "Return Reason"). The ACH Rules require that the clearing and settlement process take no more than 3 days.

Occasionally the person's account at the Paying Bank will not honor the completion of the ACH request and it will be rejected by the Paying Bank due to a Return Reason. The rejection may occur after the HSA account has already been credited to reflect the higher balance. When this occurs, the Receiving Bank would like to automatically reverse the electronic credit in the person's HSA account.

Question A: In situations where ACH requests are rejected because of a Return Reason, may the Receiving Bank automatically reverse the electronic credit to an HSA account without violating the HSA Nonforfeitability Rule?

Proposed Response A: Yes. Even though the amount shows up as a credit to the HSA account holder's HSA balance, for purposes of the HSA Nonforfeitability Rule, the amount is conditional until the deposit has cleared the ACH network. Until the clearing occurs, the HSA account holder is not deemed to have an "interest" in the amount of the credit. Thus, the amount credited to the

person's HSA is not included in the "balance in his account" for purposes of the HSA Nonforfeitability Rule and the credit may be automatically reversed without violating the HSA Nonforfeitability Rule. Whether the person wishing to deposit money into an HSA account is the account holder or some other person (such as the account holder's employer) has no impact on the proposed answer.

The bank accepts deposits made by check to a person's HSA. Upon receipt of a check the bank immediately allows funds to be deposited into the person's HSA account. The HSA account holder can view his or her HSA account and immediately believe that his or her HSA account contains the amount of money that is deposited. The HSA account holder has immediate access to those funds.

In the days following the deposit, the check may be returned by the payee's bank for several reasons to include but not limited to insufficient funds, account closed, no account found, stop payment, improper endorsement, and fraud. When this occurs the bank may be required to return the funds to the payee's bank.

IRS Response A: The Service representative agrees with the proposed response. Until the funds finish the ACH process, the person does not have an interest in the credit. As a result, the Receiving Bank can reverse the payment out and it is not considered a forfeiture because the person never really had it.

Question B: In situations where the bank accepts a deposit by check into an HSA account and the check is later returned for a valid reason, may the bank automatically reverse the credit to an HSA account without violating the HSA Nonforfeitability Rule?

Proposed Response B: Yes. Even though the amount shows up as a credit to the HSA account holder's HSA balance, for purposes of the HSA Nonforfeitability Rule, the amount is conditional until the deposit has cleared the banking system. Until the clearing of the check occurs, the HSA account holder is not deemed to have an "interest" in the amount of the credit. Thus, the amount credited to the person's HSA is not included in the "balance in his account" for purposes of the HSA Nonforfeitability Rule and the credit may be automatically reversed without violating the HSA Nonforfeitability Rule. Whether the person wishing to deposit money into an HSA account is the account holder or some other person (such as the account holder's employer) has no impact on the proposed answer.

IRS Response B: The Service representative agrees with the proposed response. The bank can reverse the credit and it is not considered a forfeiture because the person never really had the interest because the person never really paid the amount.

5. § 401(a) – Money Purchase Pension Plan Distributions

May a participant in a money purchase pension plan receive a distribution when he or she switches from being a common-law employee of the plan sponsor to being a leased employee?

Proposed Response: No. Because a leased employee is treated as an employee of the recipient (here, the plan sponsor), the participant has not incurred a severance of employment entitling the participant to a pension plan distribution. This is the same rule as for Section 401(k) plan distributions.

IRS Response: The Service representative generally agrees with the proposed response. No, the participant has not incurred a severance from employment entitling the participant to a pension

plan distribution. This is similar to whether a participant would be entitled to receive a distribution from a Section 401(k) plan before the participant otherwise becomes eligible. The preamble to the final Section 401(k) regulations notes that because an individual who is a leased employee, as defined in Section 414(n) of the Code, is treated as an employee of the recipient of the services for purposes of Section 410(b) of the Code, unless the safe harbor provisions of Section 414(n)(5) of the Code are met, meaning that the individual is covered by another plan and leased employees do not constitute more than 20% of the workforce, the individual does not incur a severance from employment.

6. § 401(a)(4) – Imputed Service

Hospital A and Hospital B are two nonprofit corporations that are exempt from tax under Section 501(c)(3) located in the same state. Hospital A and Hospital B are not under common control, but Hospital A is the sole member of Hospital B and there are financial agreements between the two. Each hospital maintains a Section 401(k) plan. From time-to-time, an employee ceases to work at one hospital and goes to work at the other hospital. Hospital A would like to amend its Section 401(k) plan to provide the following:

1. If an employee at Hospital B terminates employment and becomes an employee of Hospital A, the employee will be credited with prior service at Hospital B for purposes of eligibility and vesting under Hospital A's Section 401(k) plan.

2. If an employee at Hospital A terminates employment and becomes an employee of Hospital B, the employee will be credited with subsequent service at Hospital B for purposes of vesting under Hospital A's Section 401(k) plan.

Hospital B desires to amend its Section 401(k) plan in the same manner. May Hospital A amend Hospital A's Section 401(k) plan as described? May Hospital B also amend Hospital B's Section 401(k) plan in the same manner?

Proposed Response: Yes.

1. Hospital A may amend Hospital A's Section 401(k) plan to provide that if an employee at Hospital B terminates employment and becomes an employee of Hospital A, the employee will be credited with prior service at Hospital B for purposes of eligibility and vesting under Hospital A's Section 401(k) plan. *See* Treas. Reg. § 1.401(a)(4)-11(d)(3)(iii).

2. Hospital A may amend Hospital A's Section 401(k) plan to provide that if an employee at Hospital A terminates employment and becomes an employee of Hospital B, the employee will be credited with subsequent service at Hospital B for purposes of vesting under Hospital A's Section 401(k) plan.

IRS Response: The Service representative indicated that this is not a bright line answer. Treasury Regulation Section 1.401(a)(4)-11(d)(3)(iii) requires a legitimate business purpose, considering all the facts and circumstances. The Service representative indicated that in the factual situation presented, it appears to meet the legitimate business purpose requirement. The two entities have a significant relationship, are similar entities, are in the same state and have employees who work at both entities. The Service representative stated that in addition to a legitimate business purpose, Treas. Reg. Section 1.401(a)(4)-11(d)(3)(iii) also requires that there is no significant discrimination based on all the relevant facts and circumstances. Accordingly, the plan provision, in and of itself, may not by design or in operation discriminate in favor of highly compensated employees. The

hospital is going to have to look at the facts and determine the employees who are actually transferred. The Service representative also noted that the imputed service rules in Treas. Reg. Section 1.401(a)(4)-11(d)(3)(iv) apply to service under the plan after the employee moves to the other hospital.

7. § 401(a)(4) – Pre-Termination Restrictions

Do the pre-termination restrictions in Treas. Reg. Section 1.401(a)(4)-(5)(b) apply to a plan which covers only owners and highly compensated employees (or to an employer with no non-HCEs)?

Proposed Response: No. Treas. Reg. Section 1.401(a)(4)-(5)(b) provides that a defined benefit plan has the effect of discriminating significantly in favor of HCEs unless it incorporates provisions restricting benefits and distributions to certain HCEs. If the plan or employer has no nonhighly compensated employees, the employees do not need to be protected against discrimination in favor of HCEs. This is similar to the rule in Treas. Reg. Section 1.410(b)-2(b), which permits employers with no non-highly compensated employees to automatically satisfy the minimum coverage requirements.

IRS Response: The Service representative disagrees with the proposed response. The correct answer is yes. Treasury Regulation Section 1.401(a)(4)-5(b) is a plan document requirement not just an operational requirement, so all plans must contain these provisions. The regulation indicates that it does not apply if the Commissioner determines that such provisions are not necessary to prevent the prohibited discrimination that may occur in the event of early termination, but the Commissioner has not made that determination.

8. § 401(a)(9) – Individual as Successor in Interest to Initial Estate Beneficiary

Taxpayer A dies after naming his estate as beneficiary of Taxpayer A's qualified plan. The estate terminates and distributes its interest in the plan to Taxpayer B, an individual, through a trustee-to-trustee transfer in which the plan account is re-titled in the name of the deceased participant for the benefit of Taxpayer B. The transfer of the interest occurs before September 30th of the calendar year following the year of Taxpayer A's death. Does Taxpayer A have a designated beneficiary within the meaning of Section 401(a)(9)(E)?

Proposed Response: No. An estate does not qualify as a designated beneficiary, and, unlike a trust that can terminate and distribute its interest to an individual who qualifies as a designated beneficiary, a transfer of the interest from the estate to an individual before the beneficiary determination date does not eliminate the estate as beneficiary. Section 401(a)(9)(E) of the Code provides that the term "designated beneficiary" means any individual designated as a beneficiary by the employee. Treas. Reg. Section 1.401(a)(9)-4, Q&A-3, provides that only individuals may be designated beneficiaries for purposes of Section 401(a)(9), and further states that "A person that is not an individual, such as the employee's estate, may not be a designated beneficiary."

IRS Response: The Service representative agrees with the proposed response.

9. § 401(a)(9) – Required Minimum Distributions

A participant dies after naming the revocable trust of his U.S. citizen surviving spouse as the beneficiary of his qualified plan. The trust qualifies as a grantor trust under Subchapter J. Will the qualified plan be treated as payable to the spouse individually for purposes of using determining the required minimum distributions under Section 401(a)(9)?

Proposed Response: Yes. Treas. Reg. Section 1.401(a)(9)-4, Q&A-5 provides:

> (a) If the requirements of paragraph (b) of this A-5 are met with respect to a trust that is named as the beneficiary of an employee under the plan, the beneficiaries of the trust (and not the trust itself) will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9).
>
> (b) The requirements of this paragraph (b) are met if, during any period during which required minimum distributions are being determined by treating the beneficiaries of the trust as designated beneficiaries of the employee, the following requirements are met --
>
> > (1) The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
> >
> > (2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.
> >
> > (3) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable within the meaning of A-1 of this section from the trust instrument.
> >
> > (4) The documentation described in A-6 of this section has been provided to the plan administrator.

Under application of this rule, a trust that is revocable by the beneficiary would not allow the beneficiaries of the trust to be treated as having been designated as beneficiaries because it does not meet the second requirement that the trust be irrevocable. However, under Section 676(a), "the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both." Where Section 676 applies so as to ignore the separate status of the trust from the grantor for income tax purposes, the grantor trust provisions trump the requirements of Treas. Reg. Section 1.401(a)(9)-4, A-5 so that the individual grantor of a trust is treated as directly named beneficiary.

IRS Response: The Service representative disagrees with the proposed response. The correct answer is no. There is no designated beneficiary because the trust that is named as the beneficiary is revocable. Since the trust does not meet the irrevocability requirement of Treas. Reg. Section 1.401(a)(9)-4, Q&A-5(b)(2), the trust's beneficiaries cannot be designated beneficiaries.

10. § 401(a)(9) – Required Minimum Distributions for Money Purchase Pension Plans

Money purchase plans are subject to the qualified joint and survivor annuity rules and thus, where a participant has a spouse and no spousal consent is received, or where a participant has not elected the form in which to receive his benefit, he must receive a qualified joint and survivor annuity or, in the case of an unmarried participant, a single life annuity. *See Code* §§ 401(a)(11) and 417; Treas. Reg. § 1.401(a)-20, Q&A-25(a). The plan's normal retirement age is 60. There is a participant (single) who is required to take the required minimum distribution and the plan administrator sends a letter to either start an annuity or take the required minimum distribution for

the year. If the participant does not respond, what should the plan administrator do when the plan document is silent regarding this issue?

Proposed Response: Since the default form of distribution is a single life annuity, the plan administrator should automatically start an annuity on or before the required beginning date. Further, since the participant's account balance is no longer immediately distributable (because he is over the normal retirement age), it can be distributed without his consent.

IRS Response: The Service representative agrees with the proposed response, with a modification to the proposed response. Since the default form of distribution is a single life annuity, the plan administrator should automatically start an annuity on or before the required beginning date. Further, since the participant's account balance is no longer immediately distributable (because he is over the *later of* normal retirement age and age 62), it can be distributed without his consent.

11. § 401(k) – Church Plan/Volume Submitter Plan

A church employer adopts a Section 401(k) plan in 2003, using a volume submitter plan document purchased from a vendor. The employer makes timely, good-faith amendments whenever provided by the volume submitter vendor. In 2007, the employer realizes that the plan is not eligible as a volume submitter plan because the plan is a church plan under Section 414(e) of the Code for which an election under Section 410(d) of the Code has not been made. However, the employer's EIN ends in 6, which means that the plan is a Cycle A plan. By the time the employer understands that it cannot maintain a volume submitter plan, it has passed the January 31, 2007 Cycle A filing deadline for an individually-designed plan.

The employer filed for a determination letter on individually-designed plan by April 30, 2010. Can the employer use the temporary eligibility for the six-year cycle as provided in Section 19.03 of Rev. Proc. 2007-44 with respect to that filing? In the alternative, could the employer have waited until the next Cycle A filing period, which would have meant that the determination letter filing would have to be made by January 31, 2012?

Proposed Response: Revenue Procedure 2007-44 establishes the remedial amendment period for individually-designed and pre-approved plans. Section 9.03 of Rev. Proc. 2007-44 provides that the remedial amendment cycle for an individually-designed plan sponsored by an employer whose EIN ends in 6 is Cycle A. Pursuant to Section 12.01, the last day of the initial remedial amendment cycle for a Cycle A plan was January 31, 2007. However, under Section 19.03 of Rev. Proc. 2007-44, if a prior adopter of a pre-approved plan replaces that plan with an individually-designed plan, the prior adopter had until April 30, 2010 to file for a determination letter on the individually-designed plan. The plan in this example does not have a non-amender failure because all amendments were made timely and the plan should not be penalized for missing the filing deadline applicable to an individually-designed plan where the plan sponsor, in good faith, believed the plan was eligible to be a volume submitter plan. Therefore, the employer can file the plan as an individually-designed plan using either approach described above. That is, it was permissible for the employer to file with the IRS by April 30, 2010, using the temporary six-year cycle provided in Rev. Proc. 2007-44; or the employer could have waited and filed within the next Cycle A filing period (*i.e.*, by January 31, 2012).

IRS Response: The Service representative disagrees with the proposed response. Revenue Procedure 2005-16, Section 16.02(10) provides that advisory letters will not be issued to church plans described in Section 414(e) that have not made the election provided by Section 410(d). As a result, the plan described in this question was never eligible to maintain a volume submitter plan.

It was an individually designed plan when it was adopted and it is late. The determination letter application submitted April 30, 2010 was filed off-cycle, so there will be a gap in reliance. The employer should submit the plan during the second Cycle A submission period.

12. § 401(k) – Hardship Withdrawals

An employee pays for eligible medical or tuition expenses with the employee's personal credit card. The employee then requests a hardship withdrawal from the plan in the amount of the expenses. Can the plan grant the request? Assume that the hardship withdrawal request meets all plan requirements, including appropriate documentation of the expenses.

Proposed Response: Yes. The fact that the employee has charged the expenses does not render them ineligible for a hardship withdrawal. The employee is still responsible for paying the expenses. The only distinction is that the employee now owes the money to the credit card company instead of directly to the medical provider or educational institution.

IRS Response: The Plan can grant the hardship request if the "deemed necessary" requirements of Treas. Reg. Section 1.401(k)-1(d)(3)(E) are satisfied. Treasury Regulation Section 1.401(k)-1(d)(3)(E) includes the requirement of suspending deferrals for six months and taking other available distributions. If the hardship distribution does not meet the requirements of Treas. Reg. Section 1.401(k)-1(d)(3)(E), however, then the Service representative stated that there would be a question as to whether this is an immediate and heavy financial need since the employee paid for the expense with a credit card.

13. § 401(k) – Hardship Withdrawals

Assume an employee participates in both a Section 401(k) plan and a deferred compensation plan subject to Section 409A. The Section 401(k) plan permits hardship distributions using the safe harbor standards. The deferred compensation plan permits distributions due to an unforeseeable emergency that is a severe hardship including for the payment of medical expenses, the loss of property due to casualty, the need to prevent foreclosure or eviction and for funeral expenses for a spouse, beneficiary or a dependent. Assume an employee needs a distribution to pay for funeral expenses for a spouse. Is the participant required to take an unforeseeable emergency distribution from the deferred compensation plan before the participant is eligible for a hardship distribution from the Section 401(k) Plan?

Proposed Response: Yes. Treas. Reg. Section 1.401(k)-1(d)(3)(iv)(E) provides that a distribution is deemed necessary to satisfy the immediate heavy and financial need only if the employee has obtained all currently available distributions and nontaxable loans, under the plan and all other plans maintained by the employer.

IRS Response: The Service representative agrees with the proposed response.

14. § 401(k)(12) – Safe Harbor Matching Contribution Requirement

A safe harbor Section 401(k) plan provides different matching contribution formulas for non-HCEs and HCEs. Non-HCES receive an enhanced safe harbor matching contribution equal to 100% of the first 4% of compensation deferred into the plan, while HCEs receive a matching contribution equal to 50% of the first 5% of compensation deferred into the plan. Does this arrangement satisfy the requirement of Section 401(k)(12)(B)(ii) of the Code and Treas. Reg Section 1.401(k)-3(c)(4) that the rate of matching contributions made with respect to the elective deferrals of an HCE not

exceed the rate of matching contributions made with respect to the elective deferrals of a non-HCE at any rate of deferral?

Proposed Response: Yes. Section 401(k)(12)(B)(ii) of the Code and Treas. Reg. Section 1.401(k)-3(c)(4) address the cumulative rate of match for HCEs and non-HCEs, not the marginal rate. Under the arrangement described above, a non-HCE who elects to defer 5% of compensation into the plan will receive a matching contribution equal to 4% of compensation or 80% of the employee's elective deferrals, whereas an HCE who elects to defer 5% of compensation into the plan will receive a matching contribution equal to 2.5% of compensation or 50% of the employee's elective deferrals.

IRS Response: The Service representative agrees with the proposed response. Section 401(k)(12)(B)(ii) and Treas. Reg. Section 1.401(k)-3(c)(4) address the cumulative rate of match and not the marginal rate of match.

15. § 402(c)(11) – Non-Spouse Rollover by an Estate

May an estate named beneficiary by a participant make a direct rollover under Section 402(c)(11)?

Proposed Response: No. An estate is not a designated beneficiary within the meaning of Section 401(a)(9)(E), and so does not qualify for a Section 402(c)(11) direct rollover. A nonspouse beneficiary must qualify as a designated beneficiary within the meaning of Section 401(a)(9)(E) to qualify for a Section 402(c)(11) direct rollover. Section 1.401(a)(9)-4 A-3 provides that "a person that is not an individual, such as the employee's estate, may not be a designated beneficiary." An estate named beneficiary by the participant is not a designated beneficiary within the meaning of Section 401(a)(9)(E) and so cannot make a direct rollover under Section 402(c)(11).

IRS Response: The Service representative agrees with the proposed response. An estate is not a designated beneficiary, so it does not qualify for a direct rollover.

16. § 402(c)(11) – Non-Spouse Rollover by an Individual Successor Beneficiary of an Individual

Taxpayer A dies after naming Taxpayer B, his son, as beneficiary of Taxpayer A's qualified plan, and Taxpayer B then dies after naming Taxpayer C, grandson, as successor beneficiary of Taxpayer B's interest in the plan. Does Taxpayer C's status as the successor beneficiary preclude him from making Section 402(c)(11) non-spouse rollover?

Proposed Response: Yes. Only the initial beneficiary named by the participant may make a rollover under Section 402(c)(11).

Analysis: Under Section 402(c)(11), a qualified plan described in Section 401(a) must offer a direct rollover of a distribution to a nonspouse beneficiary who is a designated beneficiary within the meaning of Section 401(a)(9)(E), provided that the distributed amount satisfies all the requirements to be an eligible rollover distribution other than the requirement that the distribution be made to the participant or the participant's spouse. A direct trustee-to-trustee transfer may be made to an IRA established for the purposes of receiving the distribution "on behalf of an individual who is a designated beneficiary (as defined by section 401(a)(9)(E)) of the employee and who is not the surviving spouse of the employee . . . ." Section 401(a)(9)(E) defines "designated beneficiary" as "any individual designated as a beneficiary by the employee." Here, the successor beneficiary is an individual and would qualify as a designated beneficiary if named as

initial beneficiary by the participant, but successor beneficiaries do not qualify as "designated beneficiaries" and so may not undertake a Section 402(c)(11) rollover.

IRS Response: The Service representative agrees with the proposed response. Only the initial beneficiary named by the participant may make a rollover pursuant to Section 402(c)(11) of the Code. Section 401(a)(9)(E) defines a designated beneficiary as "any individual designated as a beneficiary by the employee." Here, the successor beneficiary is an individual and would have qualified as a designated beneficiary if he was named as the initial beneficiary by the participant, but successor beneficiaries do not qualify as designated beneficiaries.

17. § 402(c)(11) – Non-Spouse Rollover by an Individual Successor Beneficiary of a Spouse

Taxpayer A dies after naming his spouse, Taxpayer B, as beneficiary of Taxpayer A's qualified plan. Taxpayer B then dies after naming Taxpayer C, son, as successor beneficiary of Taxpayer B's interest in the plan. At no time does Taxpayer B make a spousal rollover or treat the account as her own. May Taxpayer C make a Section 402(c)(11) non-spouse rollover?

Proposed Response: No. Although Taxpayer C is an individual, and would qualify as a designated beneficiary if named directly by the participant, he is not a designated beneficiary.

IRS Response: The Service representative indicated that the facts in this question are unclear and need to specify whether the spousal beneficiary died before or after distribution had begun. If the beneficiary died before distributions had begun, then under the special rule for a surviving spouse, Taxpayer C would be a designated beneficiary. If the spousal beneficiary died after distributions had begun, then Taxpayer C would not be a designated beneficiary.

18. § 402(c)(11) – Non-Spouse Rollover by an Individual Successor Beneficiary of a See-Through Trust

Taxpayer A dies after naming Trust B as beneficiary of Taxpayer A's qualified plan. The beneficiaries of Trust B meet the requirements to be designated beneficiaries within the meaning of Section 401(a)(9)(E) at all relevant times. Trust B terminates and distributes its interest in the plan to Taxpayer C, an individual, through a trustee-to-trustee transfer in which the plan account is re-titled in the name of the deceased participant for the benefit of Taxpayer C. May Taxpayer C make a Section 402(c)(11) non-spouse rollover?

Proposed Response: No. Even though the initial beneficiary could do a nonspouse rollover under Section 402(c)(11), the successor beneficiary cannot, even though he could have done so if named as initial beneficiary by the participant.

IRS Response: The Service representative indicated that the facts in this question are unclear. If Taxpayer C is a beneficiary of the trust, then taxpayer C is considered a designated beneficiary. If Taxpayer C is not a beneficiary of the trust, then Taxpayer C is not a designated beneficiary.

19. § 402(c)(11) – Non-Spouse Rollover by an Individual Successor Beneficiary

Taxpayer A dies after naming his estate as beneficiary of Taxpayer A's qualified plan. The estate terminates and distributes its interest in the plan to Taxpayer C, an individual, through a trustee-to-trustee transfer in which the plan account is re-titled in the name of the deceased participant for the benefit of Taxpayer C. May Taxpayer C make a Section 402(c)(11) non-spouse rollover?

Proposed Response: No. The status of the successor beneficiary as an individual beneficiary does not change the analysis.

IRS Response: The Service representative agrees with the proposed response.

20. § 403(b) – Availability of Plan Loans

Question A: Can the loan agreement require that if a loan is defaulted, then the outstanding loan amount will not only be a deemed distribution but the account balance will also be reduced to offset the outstanding loan at the same time even if the participant is still employed?

Proposed Response A: No. Treas. Reg. Section 1.72(p)-1, Q&A-13(b) provides "In the event of a plan loan offset, the amount of the account balance that is offset against the loan is an actual distribution for purposes of the Internal Revenue Code, not a deemed distribution under section 72(p)." Since a Section 403(b) plan cannot allow in-service distributions, the loan cannot be reduced to offset the outstanding loan while the participant is still employed.

IRS Response A: The Service representative agrees with the proposed response, but with a revision. The proposed response concludes that Treas. Reg. Section 1.72(p)-1, Q&A-13(b) provides that "In the event of a plan loan offset, the amount of the account balance that is offset against the loan is an actual distribution for purposes of the Internal Revenue Code, not a deemed distribution under section 72(p)." The proposed response then provides that "since a Section 403(b) plan cannot allow in-service distributions, the account balance cannot be reduced to offset the outstanding loan while the participant is still employed." The Service representative stated that although a Section 403(b) plan in some cases cannot allow in-service distributions, the account balance can be reduced to offset the outstanding loan while the participant is still employed to the extent Treas. Reg. Section 1.403(b)-6(b) and Treas. Reg. Section 1.403(b)-11(e) allow such in-service distributions.

Question B: Is the following statement correct? "The failure to repay accrued interest on a loan in default creates a deemed distribution. Accordingly, another Form 1099-R must be issued in each year that the interest remains unpaid."

Proposed Response B: This is incorrect based on Treas. Reg. Section 1.72(p)-1, Q&A-19(a). Once a loan is deemed distributed, it is not treated as an outstanding loan and the interest that continues to accrue is not an additional loan. Therefore, another Form 1099-R is not necessary. However, the participant still is obligated to pay the defaulted loan and the interest will continue to accrue until the participant repays or the plan offsets the loan balance.

IRS Response B: The Service representative agrees with the proposed response, but with an additional note. Treasury Regulation Section 1.72(p)-1, Q&A-19(b) provides that a loan that is deemed distributed is considered outstanding for purposes of applying Section 72(p)(2)(a) to determine the amount of any subsequent loan to the participant or beneficiary. In other words, the loan offset can affect the availability and the maximum amount of subsequent loans to the participant or the beneficiary.

21. § 403(b) – Church Plans

In 2010, JCEB Q&A 14 raised a question about what nondiscrimination rules apply to an entity that has a Code Section 414(e) church plan ruling with respect to its Section 403(b) arrangement. The entity as described was not a Code Section 3121(w)(3)(A) or (B) "church" or "qualified

church-controlled organization" and was therefore subject to the nondiscrimination requirements of Section 403(b)(12) of the Code.

Specifically, the Service was asked about the meaning of the phrase in Section 403(b)(12) of the Code that states that a Section 403(b) plan must meet the nondiscrimination requirements listed in Section 403(b)(12) "in the same manner as if such plan were described in section 401(a)." The Q&A noted that, pursuant to Section 410(c)(1)(B) of the Code, a non-electing Section 401(a) church plan is exempted from the participation and coverage rules of Section 410(b), except to the extent of the application of the pre-ERISA coverage and participation rules.

The IRS generally agreed with the proposed response and concluded that "in the case of a non-electing Section 414(e) church plan that is subject to Section 403(b)(12), the coverage rules of Section 410(b) and the nondiscrimination requirements of Section 401(a)(4) apply to Section 403(b) plans in the same way as they would otherwise apply to a non-electing church plan subject to Section 401(a)." However, the Service, in its response, did not note Treas. Reg. Section 1.410(b)-2(e), which specifically provides that the requirements of Section 410(b) "do not apply to a plan described in section 410(c)(1) (*other than a plan subject to section 403(b)(12)(A)(i) or a plan with respect to which an election has been made under section 410(d)*). Such a plan must satisfy section 401(a)(3) as in effect on September 1, 1974." (emphasis added)

In light of the specific language in Treas. Reg. Section 1.410(b)-2(e), do the Section 410(b) coverage requirements apply to a non-electing church plan that is subject to the nondiscrimination and coverage requirements of Section 403(b)(12) of the Code, rather than the pre-ERISA 401(a)(3) coverage rules?

Proposed Response: Yes. The 2010 JCEB Q&A 14 was answered incorrectly. A non-electing church Section 403(b) plan is subject to the nondiscrimination and coverage provisions listed in Section 403(b)(12)(A)(i). One of these listed requirements is Section 410(b) of the Code. The regulations under Section 410(b) specifically provide that the Section 410(b) requirements do not apply to non-electing church plans *other than a plan subject to Section 403(b)(12)(A)(i)*. Because the church-related employer in this question is neither a Code Section 3121(w)(3)(A) or (B) "church" or "qualified church-controlled organization," the plan is one that is subject to Section 403(b)(12)(A)(i) of the Code, and therefore the plan must comply with the requirements of Section 410(b) of the Code.

IRS Response: The Service representative agrees with the proposed response. The Section 410(b) requirements apply. Under the facts presented, the plan is a non-electing church Section 403(b) plan that is subject to the nondiscrimination and coverage provisions of Section 403(b)(12)(A)(i) and one of the listed requirements of Section 403(b)(12)(A)(i) is Section 410(b) of the Code.

22. § 403(b) – Correcting Overpayments

The EPCRS procedures (Rev. Proc. 2008-50, Section 6.06(3)) provide that the employer must correct an "overpayment" from a defined contribution plan by taking reasonable steps to have the overpayment, plus appropriate interest from the date of the distribution to the date of the repayment, returned by the participant or beneficiary to the plan. If the amount is not returned to the plan, the employer must contribute the difference to the plan and that amount must be used to reduce employer contributions in the current or succeeding years. Do these same rules apply if the overpayment consists entirely of elective deferrals distributed to the participant in error?

Proposed Response: No, in this case there has been no harm to the plan if elective deferrals are distributed from a defined contribution plan in error. Therefore, as long as the employer takes reasonable steps to have these elective deferrals, plus appropriate interest, returned to the plan, the employer does not have to make a corrective contribution to the plan.

IRS Response: The Service representative agrees with the proposed response. In this case, there has been no harm to the plan if elective deferrals are distributed from a defined contribution plan in error. As long as the employer takes reasonable steps to have these deferrals, plus interest, returned to the plan, the employer does not have to make a corrective contribution to the plan.

23. § 403(b) – Excess Contributions

Treas. Reg. Section 1.403(b)-4(f)(2) provides that a contract to which a contribution is made that exceeds the Section 415(c) annual additions limit is not a Section 403(b) contract unless the excess contribution is held in a separate account which constitutes a separate account for purposes of Section 72 of the Code. Treas. Reg. Section 1.403(b)-3(b)(2) provides that if an excess annual addition is made to a Section 403(b) contract that otherwise satisfies the Section 403(b) requirements, then the portion of the contract that includes such excess annual addition fails to be a Section 403(b) contract and the remaining portion of the contract is a Section 403(b) contract. Treas. Reg. Section 1.403(b)-3(b)(2) is not satisfied unless, for the year of the excess and each year thereafter, the issuer of the contract maintains separate accounts for each such portion.

Does the requirement that a Section 403(b) plan must maintain a separate account for the portion of the contract that includes an excess annual addition mean that a Section 403(c) nonqualified account must actually be established for the participant or can the excess annual addition be corrected under EPCRS without the need for creating a separate Section 403(c) account at the time the excess annual addition is identified?

Proposed Response: Treas. Reg. Section 1.403(b)-4(f)(2) merely requires that the employer separately track the excess contributions. Thus, it is not necessary to actually establish a separate nonqualified Section 403(c) account as long as the excess annual addition is corrected in accordance with appropriate EPCRS procedures as soon as administratively practicable upon discovery.

IRS Response: The Service representative disagrees with the proposed response. Pursuant to Treas. Reg. Sections 1.403(b)-3(b)(2), 1.403(b)-3(d)(2)(ii)(B) and 1.403(b)-4(f)(1) and (2), excess annual additions must be in a separate Section 403(c) account in the plan.

24. § 403(b) – Universal Availability Notice

Is a Section 403(b) plan required to give out a "universal availability notice" each plan year?

Proposed Response: No. The Section 403(b) plan must give employees an effective opportunity to defer. However, this does not translate into an annual notice requirement. It should be sufficient for a Section 403(b) plan to inform employees of the right to defer when they are hired or otherwise provided with plan materials. The plan does not need to remind them each year.

IRS Response: The Service representative indicated that this is a facts and circumstances determination. Treasury Regulation Section 1.403(b)-5(b)(2) provides that whether an employee has been given an effective opportunity to defer is based on all of the relevant facts and

circumstances including the notice of availability of the election, the period of time during which an election may be made and any other conditions on elections.

25. § 409A – Application to Currency Protection Programs

Many multi-national employers provide currency protection programs. Under such a program an employee who is stationed outside his or her home country, and who is compensated in the currency of the country where he or she is stationed ("foreign currency") rather than in the employee's home currency, is protected against declines in value of the foreign against the employee's home currency. Often under such a plan the employer keeps track of currency fluctuations throughout the employee's foreign assignment and makes a true-up payment upon the employee's repatriation at the end of the assignment, if the net amount of compensatory payments during the assignment (expressed in home currency as of the end of the assignment) has fallen in value from the dates the compensation was originally paid. Is such an arrangement a deferred compensation plan subject to Section 409A? If so, many employers may, arguably, have difficulty satisfying the regulations, because repatriation (without termination of employment) is not a permissible payment event.

Proposed Response: A currency protection program that merely preserves the value of compensation relative to an expatriate employee's home currency is not a plan of "deferred compensation." The reason is that, *expressed in home currency*, no compensation is earned under such a program. The value of the original compensatory payment is merely preserved at a level amount over the course of the employee's assignment. Moreover such an arrangement is not intended to "defer" compensation, does not give rise to the possibility of tax abuse (since future currency fluctuations cannot be predicted, by either the employee or the employer), and generally bears no resemblance to the sort of taxpayer behavior with which Section 409A is concerned.

IRS Response: The Service representative indicated that this is an argument that should be made to Service representatives in the income recognition area. If these amounts are income, then they are deferred compensation. If these amounts are not income, then the amounts would not be deferred compensation. The Service representative indicated that his understanding is that these amounts would be includible in income, so the program is a deferred compensation plan.

26. § 409A – Linked Plans

Employer maintains a tax-qualified final average formula defined benefit plan. Employer also maintains an excess nonqualified plan, which provides benefits to employees whose benefits are limited under the defined benefit plan due to Sections 401(a)(17) and 415 of the Code. (In essence, the plan applies the benefit formula under the defined benefit plan without imposing the limits under Sections 401(a)(17) and 415 and then offsets the benefit a participant earns under the under the defined benefit plan.) Benefits earned under the excess plan on and before December 31, 2004 are grandfathered for purposes of Section 409A. Benefits earned on and after January 1, 2005 are subject to payment as of the later of attaining age 65 or a separation from service (participants, however, can modify the time and form of payment subject as permitted under Section 409A and accompanying regulations).

Employer amends its tax-qualified final average formula defined benefit plan to provide that employees hired on and after January 1, 2012 will have their benefit determined under a cash balance formula. The cash balance benefit each year is a pay credit equal to 6% of the employee's compensation for the year and is credited with interest credits at the rate of 4% each year. Under the excess plan, an eligible employee hired on an after January 1, 2012 will accrue a benefit based

on the cash balance formula to the extent the employee's benefit is limited due to Sections 401(a)(17) and 415 of the Code.

Employer also desires to give existing employees accruing benefits under the final average benefit formula a prospective election in 2011 under the defined benefit plan whether to continue accruing benefits under the final average formula defined benefit plan as of January 1, 2012 or to begin accruing benefits under the cash balance formula as of January 1, 2012. Employer also wishes to allow the election as to how prospective benefits are calculated to carry over to the excess nonqualified plan. The election does not affect the time or form of payment under the excess nonqualified plan. All benefits earned on and after January 1, 2005 will continue to be subject to the same time and form of payment provided for under the excess nonqualified plan.

If an employee who has accrued a final average formula benefit in 2011 elects to accrue future benefits under defined benefit plan using the cash balance formula effective as of January 1, 2012 (rather than the final average formula), does the change in form of formula for amount of future accruals constitute a violation of Section 409A of the Code?

Proposed Response: No. The employee's election to change the form of formula as to how future accruals are calculated does not change the time a form of payment of the benefits under the excess nonqualified plan. This is because the defined benefit plan and excess nonqualified plan will calculate the employee's final average formula benefit as of December 31, 2011. The limits under Sections 401(a)(17) and 415 of the Code as of December 31, 2011 will be used to calculate the benefit (subsequent adjustments will not be applied). Future benefits are based on the cash balance formula are calculated as a hypothetical account balance. For example, an eligible employee earning $300,000 in 2012 would accrue a pay credit of $14,700 (6% of $245,000) under the defined benefit plan and a pay credit of $3,300 (6% of $55,000) under the excess nonqualified plan (assuming the limits under Sections 401(a)(17) and 415 of the Code remain constant). The change in form of formula does not shift benefits because (i) the election is prospective, and (ii) the amount of benefits accrued prior to January 1, 2012 do not shift between the defined benefit plan and the excess nonqualified plan.

See Treas. Reg. § 1.409A-2(a)(9) ("In addition, with respect to such a [linked] nonqualified deferred compensation plan, the following actions or failures to act will not constitute a deferral election under the nonqualified deferred compensation plan even if in accordance with the terms of the nonqualified deferred compensation plan, the actions or inactions result in an increase in the amounts deferred under the plan, provided that such actions or inactions do not otherwise affect the time or form of payment under the nonqualified deferred compensation plan and provided further that with respect to actions or inactions described in paragraphs (a)(9)(i) or (ii) [which relate to elections and amendments to allow subsidized and ancillary benefits], the change in the amount deferred under the nonqualified deferred compensation plan does not exceed the change in the amounts deferred under the qualified employer plan or the broad-based foreign retirement plan, as applicable . . .") (emphasis added). *See also* Treas. Reg. § 1.409A-3(j)(5).

IRS Response: The Service representative indicated that he did not agree or disagree with the proposed response and declined to speak to the specific facts in this question. The Service representative commented that if the linkage of the plans does not change the time and form of payment under the non-qualified deferred compensation plan, then it is not going to be a problem.

27. § 409A – Substitution

An employer maintains a long-term incentive plan that covers the period from 2011 through 2014. Payment, which is designated as being made in a lump sum on March 1, 2015, is based on actual performance during the period. An employee will only receive payment if the employee (i) is employed on March 1, 2015, (ii) dies, (iii) becomes disabled, (iv) is involuntarily terminated for reasons other than cause, or (v) retires (defined as voluntarily terminating employment on and after attaining age 62). None of these events affect the time or form of payment – all payments will be made on March 1, 2015. If an employee is not employed on March 1, 2015, the employee receives a pro rata payment based on the number of full months worked during the period.

The employer decides to involuntarily terminate an employee covered under the plan as of January 31, 2013. The employer desires the employee to sign a release and discusses the termination, release, and severance with the employee. Based on these discussions, the employer agrees to retain the employee through April 30, 2013. In addition, they agree that the severance amount used as consideration for the release will be a formula the follows the formula under the long-term incentive plan and the agreement shall be to treat the employee as if the employee was employed from May 1, 2013, through December 31, 2013 (in essence, supplementing the pro rata payment under the long-term incentive plan in exchange for the release). The severance agreement states that payment for this pro rata portion determined based on the long-term incentive plan shall be paid in a lump sum on March 1, 2015.

Is the severance payment that determines an amount based on the long-term incentive plan a substitution under Section 409A? If so, given that the payment is made at the same time and in the same form, does it violate Section 409A (is it a permissible substitution or an impermissible substitution)?

Proposed Response: The severance payment is not a substitution. The amount paid is to obtain a release and not meant to make up for the amount being forfeited – the use of the formula from the long-term incentive plan to determine the amount does not change this. *See* Treas. Reg. § 1.409A-3(f). Even if it was determined to be a substitution, the use of the formula to determine the severance amount would not violate Section 409A because the severance amount is paid at the same time and in the same form as the amount under the long-term incentive plan.

IRS Response: The Service representative indicated that this is a substitution, but since the payment is being made at the same time and in the same form, it is not a problem. The Service representative indicated that the Service is concerned about the time and form of payments. The Service representative stated that this is analogous to substituting stock for cash, which is permissible.

28. § 409A – Time of Payment

Assume an employee has an employment agreement that provides for base salary and an annual bonus opportunity expressed as a percentage of the employee's base salary. Under the terms of the agreement, if the employee's employment ends prior to the last day of the year, then the employee will be entitled to a pro rata share of the bonus amount that otherwise would have been paid to the employee. Under the terms of the employment agreement, the bonus is to be paid "within 30 days following receipt of audited financial statements for the applicable year." Does the quoted language satisfy Section 409A?

Proposed Response: Yes. The quoted language complies with Treas. Reg. Section 1.409A-3(d). Under that Section, if the date specified is only a designated tax year (or a period of time during such a taxable year), then the date specified under the plan is treated as the first day of such taxable year (or the first day of the period of time during such taxable year), as applicable. If under the facts in this example payment is actually made by March 15 of the following year, then the payment will fall under the short-term deferral rule. If payment is made after March 15, then the payment will be made within a specified time period in accordance with Treas. Reg. Section 1.409A-3.

IRS Response: The Service representative disagrees with the proposed response. The timing of the audited financial statements is uncertain and there is no absolute requirement that the audited financial statements be delivered inside the short-term deferral period. This is an event that could happen outside the short-term deferral period, so regardless of when the audited financial statements are delivered, this is not a short-term deferral.

29. § 411(a) – Forfeiture of Benefits

Employer sponsors an ongoing, frozen defined contribution plan. In accordance with Treas. Reg. Section 1.411(a)-4(b)(6), the plan provides that a lost participant's benefit will be forfeited but that the benefit shall be restored should the participant come forward. In the event a benefit is forfeited pursuant to this provision and the employer must later make a contribution to the plan to restore the benefit, must that contribution be considered for purposes of Section 415 of the Code or any other testing from which a frozen plan is generally excluded? *See*, *e.g.*, Treas. Reg. §§ 1.415(c)-1, 1.401(a)(4)-2.

Proposed Response: No. Because the contribution is merely a restoration of a benefit that has already been considered for testing purposes, it does not subject the frozen plan to testing from which it would otherwise be excluded.

IRS Response: No. The reinstatement of a benefit of a formerly lost participant or beneficiary pursuant to Treas. Reg. Section 1.411(a)-4(b)(6) is not treated as a new accrual for purposes of Section 401(a)(4) or other testing purposes and is not treated as giving rise to an annual addition under Section 415(c) of the Code.

30. § 411(a)(2) – Post-NRA Adjustments Under a Cash Balance Plan

A cash balance plan credits interest equal to the rate of return on the S&P 500 Index. Participants who continue to work after the plan's normal retirement age (age 65) are treated the same way as active participants before age 65: pay credits plus interest credits based on the S&P 500. The plan does not have an offset provision of the type described in Section 411(b)(1)(H)(iii)(II) of the Code. Participants who terminate on or before age 65 but leave their benefit in the plan after age 65 do not continue to receive pay credits, but they continue to have interest credited to their accounts at a rate equal to the rate of return on the S&P 500. The plan does not provide suspension of benefits notices at age 65. The plan generally assumes a 5% interest rate to calculate actuarial equivalence.

Participant A has an account balance of $200,000 on his 65th birthday. He retires but does not submit the paperwork the plan requires to receive a distribution. For the following year, his account suffers an investment loss of $10,000, leaving his account balance at $190,000 on his 66th birthday. At that point, Participant A requests a total distribution of his accrued benefit and, with the consent of his spouse, receives a lump sum payment of $190,000. Section 411(b)(5)(B)(i)(II) of the Code is satisfied (preservation of capital).

Participant B has an account balance of $100,000 on her 65th birthday. She continues to work. She does not receive a suspension of benefits notice. For the following year, her account receives a pay credit of $10,000 but the account suffers an investment loss of $5,000, leaving the account balance at $105,000 at age 66. At that point, Participant B retires, requests a distribution of her accrued benefit in the form of a lump sum (she is single), and is paid $105,000. Section 411(b)(5)(B)(i)(II) of the Code is satisfied (preservation of capital).

Do the lump sum payments for each participant satisfy Section 411(a)(2) and Section 411(c)(3) of the Code?

Proposed Response: Yes. The preamble to Prop. Treas. Reg. Section 1.411(b)(5)-1 (published on 10/19/2010) explains that a cash balance plan "that does not comply with the suspension of benefit rules may have difficulty obtaining the relief of Section 411(a)(13)(A) if, after normal retirement age, the plan credits interest at such a low rate that the adjustments provided by the interest credits, together with any principal credits, are insufficient to provide any required actuarial increases." This refers to a plan with a below-market interest rate, for example a fixed interest crediting rate of 3%. But any true market interest crediting rate by definition maintains the actuarial value of the normal retirement benefit. *See Laurent v. PricewaterhouseCoopers LLP,* 448 F.Supp.2d 537, 549-50 (S.D.N.Y. 2006) (relying on *Lunn v. Montgomery Ward & Co.,* 166 F.3d 880, 883 (7th Cir. 1999)); *Pender v. Bank of America, Corp.,* 2010 WL 5071169, *7 (distinguishing *Contilli v. Local 705 Intern. Broth. of Teamsters Pension Fund,* 559 F.3d 720 (7th Cir. 2009)). In any event, Participant B did not experience a forfeiture because the net increase in her account balance attributable to pay credits and interest credits provided the necessary increase in value; a plan need not explicitly provide for the offset described in Section 411(b)(1)(H)(iii)(II) of the Code.

IRS Response: Where a participant in a defined benefit plan, including a cash balance plan, attains normal retirement age but does not commence receiving benefits, the plan must provide that the participant's accrued benefit under the plan is at least as great as the actuarial equivalent of the participant's accrued benefit at normal retirement age to avoid a prohibited forfeiture under Section 411(a). For a cash balance plan, the interest credits that are credited to the participant's account after normal retirement age are counted in determining whether the plan provides the actuarially equivalent benefit. There is no guidance that specifies any actuarial factors that must be used to determine the minimum level of the required actuarial adjustment, however, reasonable factors must be used for this purpose. Pay credits and interest credits can both be counted toward a reasonable actuarial adjustment only if the plan explicitly provides for the offset described in Section 411(b)(1)(H)(iii)(II). A participant's age is important in determining whether the increase in the hypothetical account balance over its level the prior year is enough to satisfy the reasonable actuarial adjustment requirement. If a plan suspends benefits in accordance with Section 411(a)(3)(B), including giving the required notice, then the annual increase in the hypothetical account need not constitute a reasonable actuarial adjustment for a participant who continues in Section 203(a)(3)(B) service. The Service representative commented that plans should seriously consider providing a suspension of benefits notice because they can avoid a lot of the issues raised in the above question by providing the notice. The Service representative also commented that if plans want to provide for an offset of the pay credits, it must be explicitly provided for in the plan document.

31. § 414(b), § 414(c) – Controlled Group

Corporation A is a nonprofit corporation that is exempt from tax under Section 501(c)(3). Corporation B is a nonprofit corporation that is taxable. Corporation B has no stock and its sole member is Corporation A. Corporation B has seven members on its Board of Directors. Of the

seven directors, Corporation A has the authority to appoint and remove three of the directors, three are selected by Corporation B, and one is a community member selected by the Board of Corporation B. Are Corporations A and B under common control for purposes of Section 414 of the Code?

Proposed Response: No. Although Corporation B is a taxable entity, it is also a nonprofit corporation. Under state law, no one owns the non-profit corporation; instead the non-profit corporation is governed by state law and controlled by its board or directors. Because Corporation B is a nonprofit corporation it will be treated in the same manner as a tax-exempt entity. Therefore, the two corporations are not under common control for purposes of Section 414 of the Code. *See* Treas. Reg. § 1.414(c)-5. *See also* GCM 39616 (March 12, 1987); Priv. Ltr. Rul. 97-22-039 (May 30, 1997); Priv. Ltr. Rul. 96-29-033 (July 19, 1996).

IRS Response: The Service representative disagrees with the proposed response. Under the facts presented, Corporation B is under common control with Corporation A because Corporation A directly or indirectly controls all of the members of Corporation B's Board of Directors.

32. § 414(v) – Catch-Up Contributions

A Section 401(k) plan permits catch-up eligible participants to separately designate the amount of catch-up contributions per payroll period. This election is in addition to the participant's regular elective deferral. The plan matches the regular elective deferrals on a payroll period basis. However, the plan does not provide for any match on catch-up contributions.

At the end of the year, the plan reviews the participant's contribution history and discovers that the participant's regular elective deferrals and catch-up contributions, combined, do not exceed the Section 402(g) limit. Is the plan now required to match those contributions that the participant had previously designated as catch-up contributions?

Proposed Response: Yes. Although a plan is not required to match catch-up contributions, no catch-up contributions were made in this case. Under Treas. Reg. Section 1.414(v)-1(b), only elective deferrals that exceed an applicable limit are considered catch-up contributions.

IRS Response: Yes. Under Treas. Reg. Section 1.414(v)-1(b), only elective deferrals that exceed an applicable limit are considered catch-up contributions. Under these facts, the participant has not made catch-up contributions and, therefore, the plan provisions provide for a match with respect to all of the participant's contributions.

33. § 416 – Top-Heavy Plans

A defined benefit plan has a January 1 valuation date for purposes of the minimum funding standards in Section 430 of the Code. Must the top-heavy valuation date also be January 1?

Proposed Response: No. According to Section 416(g)(4) of the Code, the determination date for top-heavy purposes is the last day of the plan year. The plan can have a separate valuation date for top-heavy purposes closer to the last day of the plan year.

IRS Response: Except in the case of a new plan, the top heavy determination date is the last day of the preceding plan year. The statute and regulations do not use the term "top heavy valuation date." The Section 430 valuation date is a date that is independent of the top heavy determination date. Treasury Regulation Section 1.416-1, Q&A T-25 provides generally for top heavy purposes

that the present value of an accrued benefit as of a determination date must be determined as of the most recent valuation date which is within a 12-month period ending on the determination date.

34. § 417 – Retroactive Annuity Starting Dates

If a participant elects a lump sum payable at a retroactive annuity starting date, does the Plan have to pay interest on the lump sum amount for the period from the retroactive annuity starting date to the benefit commencement date?

Proposed Response: No, interest is not required to be paid on the lump sum calculated as of the retroactive annuity starting date. Treas. Reg. Section 1.417(e)-1(b)(3)(iv)(B) requires the payment of interest on any "missed payment or payments" from the period from the retroactive annuity starting date to the date of the actual make-up payment. This requirement was intended to apply to missed annuity payments. A lump sum is not a "missed payment" for these purposes. However, in accordance with Treas. Reg. Section 1.417(e)-1(b)(v)(C), if the Plan is subject to Section 417 of the Code, the Plan will have to pay the greater of the lump sum determined as of the retroactive annuity starting date (using the applicable mortality table and applicable interest rate in effect at the retroactive annuity starting date) and the lump sum determined as of the benefit commencement date (using the applicable mortality table and applicable interest rate in effect at the benefit commencement date).

IRS Response: The Service representative disagrees with the proposed response. The Service representative indicated that the participant should receive the greater of the lump sum determined as of the retroactive annuity starting date (using the applicable mortality table and applicable interest rate in effect at the retroactive annuity starting date) and the lump sum determined as of the benefit commencement date (using the applicable mortality table and applicable interest rate in effect at the benefit commencement date). Treasury Regulation Section 1.417(c)-1(b)(3)(iv)(B) provides that in the case of a distribution with a retroactive annuity starting date, the participant receives a make-up payment to reflect any missed payment or payments from the period from the retroactive annuity starting date to the date of the actual make-up payment, with appropriate adjustment for interest. In the case of a lump sum paid pursuant to a retroactive annuity starting date, the entire amount of the lump sum is the make-up payment and is thus subject to the requirement to provide an appropriate adjustment for interest.

35. § 432 – Annual Updates to Rehabilitation Plans

Sections 432(e)(3)(B)(i) and (ii) of the Code require that the plan sponsor annually update the rehabilitation plan and annually update any schedule of contribution rates to reflect the experience of the plan. Sections 432(c)(6)(A) and (B) of the Code have similar provisions for a plan in endangered status regarding updates to the funding improvement plan and its schedules. When do these annual updates have to be completed?

Proposed Response: As the updates to the rehabilitation plan and funding improvement plan must be filed with the plan's annual report, it is reasonable to conclude that both updates (to the plans and the schedules) must be made no later than the end of each plan year subsequent to the initial plan year in which the plan was certified critical or endangered. *See* Sections 432(e)(3)(B)(i) and 432(c)(6)(A) of the Code.

IRS Response: It is reasonable to conclude that both updates to the plans and to the schedules must be made no later than the end of each plan year subsequent to the initial plan year in which

the plan was certified critical or endangered. *See* Sections 432(e)(3)(B)(i) and 432(c)(6)(A) of the Code.

36. § 432 – Implementation of Default Schedule

A multiemployer pension plan is certified critical for the plan year beginning January 1, 2010. The plan sponsor timely adopts a rehabilitation plan with two schedules of contributions – one corresponding with the default plan and one corresponding with another plan (the "non-default plan"). The plan sponsor timely provides the schedules of contributions to the bargaining parties. The collective bargaining agreement in effect as of January 1, 2009 expires June 30, 2010. The bargaining parties incorporate into their collective bargaining agreement the schedule which corresponds with the non-default plan prior to June 30, 2010. The bargaining parties negotiate a renewal of the collective bargaining agreement for the period July 1, 2010 through June 30, 2011. In early 2011, the Trustees amend the rehabilitation plan to provide for higher contributions for the non-default plan and provide this schedule to the bargaining parties. If the bargaining parties do not agree to the higher contributions within 180 days of June 30, 2011, is the plan sponsor required to implement the default schedule?

Proposed Response: No. Section 432(e)(3)(C) of the Code only addresses implementation of the default schedule within 180 days of the expiration of the collective bargaining agreement in effect at the time the plan entered critical status. In the above example, the bargaining parties did adopt a schedule prior to the expiration of the collective bargaining agreement in effect at the time the plan entered critical status.

IRS Response: The Service representative agrees with the proposed response, subject to its interpretation of the facts. The Service representation is interpreting the sentence "The bargaining parties negotiate a renewal of the collective bargaining agreement for the period July 1, 2010 through June 30, 2011" to mean that the parties negotiate a renewal of the collective bargaining agreement for the period July 1, 2010 through June 30, 2011 under the same terms as the expired collective bargaining agreement. The Service representative is interpreting this sentence to mean that there is a new collective bargaining agreement that adopts a schedule that is consistent with the plan. The Service representative stated that the default schedule is a one-time imposition and it can be avoided once the bargaining parties have agreed to a schedule.

37. § 432 – Payment of Surcharge

The bargaining parties have a collective bargaining agreement from June 1, 2010, through May 31, 2011. The multiemployer pension plan year is the calendar year. As of January 1, 2010, the pension fund was certified critical. The Trustees adopted a rehabilitation plan and prior to the imposition of any employer surcharges under Section 432(e)(7), on April 1, 2010, the bargaining parties amended the collective bargaining agreement to include one of the schedules set forth in the rehabilitation plan. In February 2011, the rehabilitation plan and schedules were adjusted per Sections 432(e)(3)(B)(i) and (ii), but under Section 432(e)(3)(B)(iii), the collective bargaining agreement was not amended to incorporate any amended schedules. If the agreement expires on May 31, 2011, and the parties have not agreed to one of the adjusted schedules, would the contributing employers have to pay a surcharge under Section 432(e)(7)?

Proposed Response: No. By its terms, the surcharge under Section 432(e)(7) expires on the effective date of *a* collective bargaining agreement (or other such agreement) that includes terms consistent with a schedule presented by the plan sponsor under Section 432(e)(1)(B)(i), as modified under subparagraph (B) of paragraph (3). In the example, this was done on April 1, 2010. There is

no provision in Section 432(e)(7) of the Code requiring the surcharge where updated schedules are not subsequently incorporated. (The reference in Section 432(e)(7) to adoption of a schedule "as modified by subparagraph (B) of paragraph (3)" applies where the bargaining parties did not adopt the initial schedules under Section 432(e)(1)(B)(i)).

IRS Response: The Service representative agrees with the proposed response. Once the bargaining parties have agreed to a collective bargaining agreement that includes the rehabilitation plan and schedules, the surcharge will not be imposed later, even if there is a disagreement or failure to agree on an updated schedule. The Service representative also pointed out that pursuant to the statute, the schedules were "updated" rather than "adjusted" in February 2011.

38. § 4971 – Amount of Required Contribution

Section 4971(g)(2) of the Code provides that if any funding improvement plan or rehabilitation plan in effect under Section 432 of the Code with respect to a multiemployer plan requires an employer to make a contribution to the plan, there is a tax imposed on each failure of the employer to make the required contribution within the time required under such plan. The amount of the tax imposed is equal to the amount of the required contribution the employer failed to make in a timely manner. Is the "amount of the required contribution" the total contribution required to be made under the funding improvement plan or rehabilitation plan, or the difference in the contribution required prior to the implementation of the funding improvement plan or rehabilitation plan and the amount required under the funding improvement plan or rehabilitation plan?

Proposed Response: The "amount of the required contribution" is the total required contribution under the funding improvement plan or rehabilitation plan, not just the amount by which the contribution was increased by the funding improvement plan or rehabilitation plan. Section 4971(g)(2) refers to the "required contribution," not just an increase in contribution.

IRS Response: The Service representative agrees with the proposed response.

39. § 4971 – Effective Date of Funding Improvement Plan

Section 4971(g)(2) of the Code provides that if any funding improvement plan or rehabilitation plan "in effect" under Section 432 of the Code with respect to a multiemployer plan requires an employer to make a contribution to the plan, there is a tax imposed on each failure of the employer to make the required contribution within the time required under such plan. Is a funding improvement plan or rehabilitation plan considered "in effect" when adopted by the trustees, or after one of the schedule of contributions set forth in the funding improvement plan or rehabilitation plan have been adopted by the bargaining parties?

Proposed Response: The funding improvement plan or rehabilitation plan is in effect after one of the schedule of contributions set forth in the funding improvement plan or rehabilitation plan have been adopted by the bargaining parties, as without adoption by the bargaining parties, the employer is under no obligation to make the contribution required by the funding improvement plan or rehabilitation plan.

IRS Response: The funding improvement plan or rehabilitation plan is in effect for an employer after one of the schedules of contributions set forth in the funding improvement plan or rehabilitation plan have been adopted by the bargaining parties or imposed by default. Absent either of those, the employer is under no obligation to make the contribution required by the funding improvement plan or rehabilitation plan.

40. § 4971 – Reporting of Failure to Make Contribution

Section 4971(g)(2) of the Code provides that if any funding improvement plan or rehabilitation plan "in effect" under Section 432 of the Code with respect to a multiemployer plan requires an employer to make a contribution to the plan, there is a tax imposed on each failure of the employer to make the required contribution within the time required under such plan. Does the plan have an obligation to report to the IRS when an employer has failed to make such a contribution to the plan?

Proposed Response: No. As this is a tax on the employer, it is the employer's responsibility to report that such amount is due and owing to the IRS.

IRS Response: The Service representative agrees with the proposed response.