
AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

MAY MEETING 2009

COMMITTEE ON EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS

INTERNAL REVENUE SERVICE

MAY 7-9, 2009

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 8, 2009. 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(h) – Taxation of Health Benefits

After the termination of COBRA continuation coverage, an employer continues coverage for the spouses of former highly compensated executives under a self-insured group health plan. The spouses pay the employer, on an after-tax basis, a premium equal to the fair market value of the health coverage as determined by the employer's actuaries (and that exceeds the COBRA premium). Are the benefits the spouses receive non-taxable under Section 104 or taxable under Section 105(h)?

Proposed Response: The former executives and their spouses may exclude the benefits under the health plan from income. Section 104 provides that amounts received through accident or health insurance for personal injuries or sickness are not included in income unless the amounts are (a) attributable to employer contributions that were not included in the employee's income or (b) paid by the employer. Thus, if an individual pays the fair market value of the cost of coverage provided on an after-tax basis, the benefits received under such coverage are excluded from the individual's income. Therefore, if a spouse of a former executive pays the employer an amount equal to the fair market value of the coverage on an after-tax basis, the value of the benefits received is not included in income for the executive or the spouse. Because the benefits are non-taxable under Section 104, Section 105(h) does not apply.

IRS Response: The Service representative agrees that the benefits are excludable from income under Section 104(a)(3), but only if the self-insured medical plan is an arrangement having the effect of accident or health insurance. If not, the benefits are taxable. Section 105(h) does not apply. The Service representative declines expressing an opinion on how fair market value is determined.

2. § 104, § 105(b), § 106 – Imputing Value of Employer Provided Coverage

A company maintains a self-funded group health plan. Hourly employees are required to wait 60 days prior to being eligible to participate in the self-funded group health plan. The company permits salaried employees to immediately enter into the self-funded group health plan upon hire. However, for the first 60 days of participation in the self-funded group health plan, the company imputes taxation on the fair market value of the self-funded group health plan coverage to the salaried employees. The fair market value of coverage is determined by computing the applicable premium for COBRA purposes on an actuarial basis. After the initial 60-day period, both salaried and hourly employees receive the exact same group health plan coverage. Are the implications of Section 105(h) avoided by imputing taxation to the salaried employees on the fair market value of the coverage provided for the first 60 days of coverage? Will the benefits received by the salaried employees during the first 60 days of coverage remain nontaxable under Section 104(a)(3)?

Proposed Response: Yes to both questions. By imputing taxation on the fair market value of the self-funded group health plan coverage to a salaried employee during the first 60 days of eligibility, Section 105 will not be implicated. Instead, the benefits actually received by the salaried employee are excludable from gross income under Section 104(a)(3), which provides that health plan benefits that are paid in full by an employee are excludable from the employee's income.

Section 106 provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. However, an employee can either pay the cost of coverage on an after-tax basis or the employer can impute the value of such coverage to an employee. If this was an employer-sponsored insured group health plan, Section 105 would not apply to a salaried employee who paid 100% of the premium on an after-tax basis. Instead,

Section 104(a)(3) would apply to exclude from taxation the benefits received under the insured group health plan. With a self-funded plan, a portion of the coverage is clearly employer provided; however, the fair market value can be determined when computing the applicable premium for COBRA purposes on an actuarial basis. Instead of the employee paying on an after-tax basis, this company imputes the fair market value of the self-funded plan coverage to the employee.

Section 105 is implicated if the employer contributions toward coverage are not included in the employee's gross income. In this scenario, the employer contributions are included in the employee's gross income. Therefore, Section 105 will not apply (nor will the provisions of Section 105(h)). Instead, amounts received through accident or health insurance that are not excludable under Section 105 will be excludable under Section 104(a)(3) if they are attributable to employer contributions that were included in the employee's income, such as in this case.

IRS Response: The Service representative agrees with the proposed responses, but declines expressing an opinion on how fair market value is determined.

3. § 105 – Non-Tax Dependents and Imputed Income

Question A: Many employer health plans allow non-tax dependents as defined by Section 152 of the Code (e.g., some domestic partners and adult children) to receive health care coverage under the employer-sponsored plan. The exclusion from income under Sections 105 and 106 of the Code is not available to non-tax dependents. Therefore, the fair market value of health coverage provided to the non-tax dependent is imputed as income to the employee less any employee after-tax contributions for the coverage. In some family situations adding a non-tax dependent does not change the overall cost of the health insurance coverage. For example, an employee has "family coverage" which provides health benefits to the employee and his two children. Employee gains a domestic partner who is not the employee's tax dependent (qualifying relative) under Section 152 of the Code. The "cost" associated with the coverage did not increase as a result of adding this non-tax dependent. The employer needs to include the fair market value of the non-tax dependents coverage as income to the employee. How does the employer do this?

Question B: What if the amount imputed as income to the employee exceeds the actual cost of the coverage? For example, assume an employee with three non-tax dependents is allowed to participate and provide coverage for his family at no cost (employer pays the full premium). The total premium associated with the coverage is \$1,000. The employer will need to impute as income some portion of this premium allocable to the three non-tax dependents. Using the COBRA rate as an estimate of the fair market value of the coverage, this value is \$400 per individual. However, the total amount imputed as income (\$1,200) is more than the actual premium charged by the plan (\$1,000). Does the employer need to impute \$1,200 as income or can the imputed income be capped at the actual premium associated with the coverage (\$1,000)?

Question C: In the example in Question B, the cost for the employee to be on the plan is \$400 which is excludable from the employee's income under Section 106 of the Code. The remaining premium associated with the health coverage is \$600. May the employer impute \$600 as income to the employee for the three non-tax dependents?

Proposed Response A: The employee's non-tax dependent is receiving a benefit that is not an excludable fringe benefit under the Code. Therefore, the fair market value of the cost to enroll one individual in the health plan must be included as income to the employee. The COBRA premium (less the 2% administration fee) is a reasonable estimate of the fair market value of the coverage. It would be correct to impute the COBRA premium for a single individual as the fair market value for

the non-tax dependent. Private Letter Ruling 200108010 (November 17, 2000) and Private Letter Ruling 9850011 (September 10, 1998) do not disagree with the use of the COBRA premium (less 2%) as the fair market value, however, these private letter rulings may only be relied upon by the taxpayer to which they were provided.

Proposed Response B: The fair market value of the coverage for each non-tax dependent must be included as income to the employee less any after-tax contributions. Only imputing income up to the premium amount may understate the value of the benefit received by these non-tax dependents.

Proposed Response C: This does not accurately reflect the imputed income because the fair market value for one individual to receive benefits under this plan is \$400. Imputing only \$600 as income to the employee for coverage of three non-tax dependents understates the fair market value by \$600.

IRS Response: The Service representative agrees that if the individual receiving coverage is a non-tax dependent, the fair market value of the coverage must be treated as income to the employee even if the cost of the coverage does not change as a result of adding the non-tax dependent. The Service representative declines expressing an opinion on how the fair market value of the coverage is calculated.

4. § 125 – Employer-paid Disability Premiums

Does third-party short-term disability, where premiums for such disability are paid by the employer, received by an employee on a leave of absence make the leave of absence other than “unpaid” for purposes of the Section 125 cafeteria plan election change rules?

Proposed Response: No, third-party short-term disability is an obligation of a separate party from the employer and the default rule is that the third party is responsible for tax withholding and reporting. Thus, from the employer/employee perspective, the leave is “unpaid” for purposes of the Section 125 cafeteria plan rules.

IRS Response: The Service representative disagrees with the proposed response. Since the employee is receiving disability benefits, this should be considered a paid leave of absence for purposes of the Section 125 cafeteria plan election change rules.

5. § 264 – Deductions for Contributions to a VEBA

How does Revenue Ruling 2007-65 apply to large corporate taxpayers offering death benefits to active employees when funded with group term life insurance held in a VEBA?

Background: In Revenue Ruling 2007-65 the Service was dealing with an abusive tax shelter being marketed to small businesses, whereby the taxpayer funded a VEBA or a taxable welfare benefit irrevocable trust. The trust would then acquire a life insurance policy on one or more employees, with the trust as owner and beneficiary of the insurance. The trust was then obligated to remit these proceeds to the designated beneficiary of the trust. The taxpayer claimed a deduction for the contribution to the trust which equated to the premiums paid by the trust for the insurance.

The Service ruled that the taxpayer directly or indirectly benefitted from the insurance proceeds and that Section 264(a) therefore prevented any deduction for the contribution. The Service also stated that this is the same holding regardless of the type of insurance (term or permanent) and the ownership structure (with or without a trust and whether a VEBA or taxable trust).

Rationale: If the ruling is as broad as it appears, then Section 264(a) should prevent the deduction for contributions even by widely-held corporations offering group term insurance benefits to its rank and file employees regardless of how the policies are owned (*e.g.*, even if owned by an irrevocable trust). This seems to be an unintended consequence of a ruling aimed at abusive tax shelters and could be immensely disruptive to processes that are generally considered acceptable.

Proposed Response: If Revenue Ruling 2007-65 is taken at face value, it seems that the taxpayer gets no deduction for its contributions to the VEBA to the extent those costs are derived from the cost of the group term life insurance, based on Section 264(a) as applied in the Revenue Ruling. The desired answer is the opposite: that these taxpayers are not subject to the holding in the ruling. This ruling needs to be limited to its facts and specifically exclude corporations that are not engaged in the tax shelter identified in the Revenue Ruling.

IRS Response: Revenue Ruling 2007-65 is carefully written. It is not a matter of whether there is a tax shelter involved. The Revenue Ruling applies the rules of Section 419 to determine what is a direct cost and what is a qualified direct cost, which ultimately leads to the deduction limit. To make this determination, look at what amount would be deductible to the employer if the welfare benefit trust did not exist. In other words, what is the deduction if the employer provided the benefits directly to the employee? The fact pattern of the Revenue Ruling involved a cash value life insurance policy. If the employer is providing a cash value life insurance policy directly to employees, Section 264 will limit the deduction. Therefore, no deduction is available under Section 419 of the Code.

If the policy would not be deductible if it was provided directly by the employer, the employer is not directly or indirectly a beneficiary. For example, in a one-year term policy, the employer is not directly or indirectly a beneficiary. All the employer gets from the policy is the employee's services. This is a type of compensation. The employer does not have any rights to the policy. If the policy has a one-year term and Section 264 is applied, there will not be a deduction limitation. If the policy has a cash value, there will be a deduction limitation. It is not clear whether Section 264 applies to a level term policy which does not have a cash value. In this question, the basic analysis is to look at Section 264 without the welfare benefit trust to see if a deduction is available for those premiums.

6. § 401 – Disqualifying Plan Provisions in Determination Letter Applications

If a plan provision being reviewed in a determination letter context is seen to be disqualifying, is it possible to modify the provision retroactively and either (a) restore to the plan any distributions made while the determination letter request was pending or (b) retroactively modify the tax treatment of those distributions? For example, if shutdown benefits are paid from the plan, sidestepping FICA, would an appropriate correction be to have the plan sponsor pay the FICA on the assumption that income tax already would have been paid by the participants on those benefits?

Proposed Response: Either correction method described above is acceptable.

IRS Response: The Service representative indicated that the proposed correction methods in the question generally should work, but has no comment on the FICA example described in the above question. The Service representative stated that it was not clear what the disqualifying amendment was in the above question, but if it was an amendment to maintain the qualification of the plan that was timely adopted and the plan was submitted before the end of the cycle deadline, the Section 401(b) period is extended until 91 days following the date of the favorable determination letter. Therefore, the amendment could be corrected while the determination letter application was

pending. The Service representative cautioned about the timing of Section 411(d)(6) amendments and certain discretionary amendments and indicated that the response is not blanket approval to follow this approach. Prior to following this approach, all of the facts must be examined, but generally this approach may be followed and this amendment may be made on a retroactive basis.

7. § 401, § 436 – Interaction of High-25 Rules and Benefit Restriction Rules

Treasury Regulation Section 1.401(a)(4)-5(b)(3) contains rules limiting distributions to “restricted employees” (25 most highly-paid employees) under a pension plan. The limitation is not applicable in certain situations, including if the funding level of the plan after payment to the restricted employee is at least 110% of the value of “current liabilities,” as defined in Section 412(l)(7) of the Code, which is no longer applicable.

Effective for plan years beginning after December 31, 2007, new Section 436 of the Code provides rules that limit accelerated distributions from plans that have specified funding levels lower than 100%, which addresses the same type of concerns that motivated the above-cited regulation. Will the Service provide guidance on how the two rules interact?

Proposed Response: Section 436 of the Code is designed to prevent underfunded plans being depleted by lump sum distributions to any employee (not just the most highly-paid 25), so there is no longer any need for the rule contained in Treasury Regulation Section 1.401(a)(4)-5(b)(3) and it will be withdrawn. In contrast to the comprehensive statutory rules of Section 436 of the Code, the rules contained in Treasury Regulation Section 1.401(a)(4)-5(b)(3) are simply regulatory constructs, which should be superseded by the comprehensive statutory scheme of Section 436 of the Code.

Furthermore, there is precedent for this position in that Treasury Regulation Section 1.401(a)(4)-5(b)(3) was originally derived from Treasury Regulation Section 1.401-4(c). When the rules in Treasury Regulation Section 1.401(a)(4)-5(b)(3) were finalized, the Service determined that the new rules made the prior rules obsolete, apparently in the interest of avoiding confusion as to which rule would apply. (*See* preamble to the final regulations under Section 401(a)(4) at 3. *Nondiscriminatory Effect of Plan Amendments and Terminations*, paragraph 4; T.D. 8360.)

Alternative Proposed Response: Treasury Regulation Section 1.401(a)(4)-5(b)(3) should have no application when Section 436 of the Code applies. For cases where Section 436 of the Code does not apply, the reference to Section 412(l)(7) of the Code should be replaced with a reference to the present value of all benefits accrued or earned under the plan as of the beginning of the plan year in which payment is to occur, determined utilizing the actuarial assumptions and methodology used in determining the funding target under Section 430(d).

IRS Response: While there is significant overlap between the high-25 limitations and the Section 436 rules, they have different functions and they both still apply. The high-25 limitations require consideration for lump sums up to a 110% funding level while Section 436 permits the payment of lump sums if the plan has an 80% funding level. Accordingly, the Service representative believes there is a place for both limitations to apply. The regulations under Section 401(a)(4), which refer to current liability as the measurement for determining funding status, provide that a plan may use any reasonable, consistent method to determine current liability. The Service representative believes that in this environment using the funding target as a replacement for the current liability calculation is a reasonable approach. The Service representative indicated that the Service hopes to revise the regulations under Section 401(a)(4) to formalize this process, but in the meantime, the Service representative recommended using the funding target as the measurement.

8. § 401(a), § 414(u) – Deadline for Optional HEART Act Changes

When must qualified plans be amended for optional changes pursuant to the Heroes Earnings Assistance and Relief Tax Act of 2008 (the “HEART Act”)?

Proposed Response: Plans do not need to be amended for optional HEART Act changes until the last day of the plan year beginning on or after January 1, 2010, even if the optional change is implemented prior to the plan year beginning on or after January 1, 2010.

IRS Response: The Service representative indicated that they will address this in published guidance soon.

9. § 401(a)(9) – Hybrid Defined Benefit Plans with Deferred Compensation Features

Employer A, an agency of State M, has established Plan G (a qualified plan under Section 401(a) of the Code) which is a “hybrid plan” described under Section 414(k) of the Code. Under Plan G, participant contributions are picked-up by Employer A within the meaning of Section 414(h)(2) of the Code and are remitted to a separate individual account. The balance of the individual account is adjusted on a quarterly basis according to quarterly valuations that reflect actual investment returns on the amounts contributed to the account. Upon retirement, the participant is entitled to receive the vested account balance of the separate account in a lump sum. Plan G also provides a pension that is funded wholly by employer contributions payable as an annuity over the life of the retiree that is based on the years of service and the final average salary of the participant. The terms of the plan concerning the separate account are generally summarized as follows:

1. The plan provides that contributions to the separate account are tested under Section 415(c) of the Code and its regulations as though part of a separate defined contribution plan.
2. The plan follows the requirements of Notice 87-13, wherein it is stated that the separate account would be credited with actual earnings and losses, rather than a stated interest rate or credit.
3. The plan provides that the separate account is treated as a separate contract for basis recovery purposes.
4. The plan provides that while the separate account is tested under Section 415(c) of the Code, the benefit accruals under the pension component of the plan are tested under Section 415(b) of the Code.

Participant P separated from employment and attained age 70½ in calendar year 2007. She has been receiving required minimum distribution amounts over her lifetime attributable to calendar years 2007 and 2008 with respect to her interest in the pension portion and separate account under Plan G.

Does the required minimum distribution moratorium under Section 401(a)(9)(H) of the Code permit Participant P to not receive required minimum distribution amounts from the separate account under Plan G for calendar year 2009?

Proposed Response: Section 401(a)(9)(H) of the Code waives the required minimum distribution from Participant P’s separate individual account under Plan G for calendar year 2009.

Section 414(k) of the Code describes certain defined benefit plans which provide a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant (“hybrid plans”). “Hybrid plans” are treated as defined contribution plans with respect to minimum participation standards under Section 410 of the Code. For purposes of Sections 72(d) (relating to treatment of employee contributions as separate contract), 411(a)(7)(A) (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 401(m) (relating to nondiscrimination tests for matching requirements and employee contributions) of the Code, “hybrid plans” are treated as consisting of a defined contribution plan to the extent benefits are based on the separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan.

For purposes of Section 4975 (relating to tax on prohibited transactions) of the Code, “hybrid plans” are treated as defined benefit plans. Governmental plans, as defined under Section 414(d) of the Code, are not subject to Sections 410, 411, 401(m), and 4975 of the Code.

Section 401(a)(9)(H) of the Code, as added by Section 201(a) of the Worker, Retiree, and Employer Recovery Act of 2008 (“WRERA”), waives the minimum required distribution for calendar year 2009 for the following:

- (I) in [Code] Section 403(a) or 403(b),
- (II) a defined contribution plan which is an eligible deferred compensation plan described in [Code] Section 457(b) but only if such plan is maintained by an employer described in [Code] Section 457(e)(1)(A), or
- (III) an individual retirement plan.

Defined contribution plans described in Code Section 401(a) are defined in Code Section 414(i).¹ Code Section 414(i) states:

For purposes of this part, the term “defined contribution plan” means a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant’s account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account.

Plan G is a Code Section 414(k) “hybrid plan” with distinct defined benefit and defined contribution components. The defined contribution component of Plan G is “based solely on the amount contributed to the participant’s account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant’s account.” Therefore, to the extent the separate account feature of Plan G falls within the definition of “defined contribution plan,” participants will not be required to take required minimum distributions amounts from their separate individual accounts for calendar year 2009.

E. Variations on Factual Scenario: It seems that the same analysis would apply even if Plan G is not a Code Section 414(k) “hybrid plan” so long as the value of the employee’s account is based on the actual investment performance of plan assets. We are aware that such defined benefit plan

¹ “Under the provision, no minimum distribution is required for calendar year 2009 from individual retirement plans and employer-provided qualified retirement plans that are defined contribution plans (within the meaning of section 414(i)).” Joint Committee on Taxation, “Technical Explanation of H.R. 7327, the ‘Worker, Retiree, and Employer Recovery Act of 2008,’ as passed by the House on December 10, 2008” (JCX-85-08) (“Comm. Rep.”) at 26, December 11, 2008.

structures do not fit squarely within the categories set forth under Code Sections 401(a)(9)(H)(i)(I) through (III).

However, there is a strong policy argument consistent with Congressional intent behind the passage of WRERA's amendments to Code Section 401(a)(9) that the required minimum distribution moratorium should apply to benefit structures that track market fluctuations. The following excerpt from the Congressional Record of December 11, 2008, showing comments by Senate Finance Committee Chair Max Baucus, illustrates the animus behind the Act, referenced therein as H.R. 7327.

Mr. BAUCUS. Mr. President, in a moment I will ask unanimous consent that the Senate proceed to passage of H.R. 7327, the pension bill. Before I do that, I wish to say this is very important relief for seniors and for the country. The bill includes a provision that would allow seniors who are 70½ years of age not to have to make withdrawals from their IRA accounts that the current law requires. Under current law, if you are 70½ or older, you must begin to withdraw significant amounts from your 401(k) accounts or IRA accounts and if you don't, you pay a big penalty. At these times it is not wise to require that, because the accounts are lower in value and they should not have to make those withdrawals if they don't want to.

* * *

Mr. BAUCUS. Mr. President, we are living through an unprecedented economic downturn. Over the past 15 months, the Dow Jones Industrial companies have lost more than one-third of their value. An end does not appear in sight.

This sharp market decline hurts more than just Wall Street. It hurts every American with a retirement plan. When the market drops, so do the assets in pension plans.

Over the past 15 months, because of the current financial crisis, retirement accounts have lost as much as \$2 trillion in assets due to the current financial crisis. That is \$2 trillion that disappeared from the retirement accounts of American workers. And that is \$2 trillion that disappeared from the accounts of pension plans.

Congress must act now to protect individual retirement accounts and pension benefits and assets.

This bill provides relief for seniors age 70½ and older whom current law requires to take distributions from their retirement plans.

Individuals would have the option to keep their retirement savings where they are. We should not force them to take out huge portions of their savings when the market is down.

Cong. Rec. S10914-10915 (Dec. 11, 2008).

IRS Response: Treasury Regulation Section 1.401(a)(9)-8, Q&A-1 provides that a Section 414(k) plan is treated as two separate plans for purposes of Section 401(a)(9). Accordingly, the piece of the plan that is treated as a defined contribution plan is entitled to the relief from Section 401(a)(9) for 2009 and the piece of the plan that is treated as a defined benefit plan is not entitled to the relief from Section 401(a)(9) for 2009.

10. § 401(a)(9) – Plan Amendments to Eliminate 2009 Required Minimum Distributions

What plan amendments, if any, are required to address the WRERA provision eliminating the need for participants to receive required minimum distributions from a defined contribution plans for 2009? What is the timing requirement for any amendment?

Proposed Response: The following are possible responses to the timing requirement for any amendment.

(a) No amendment is required if the plan document incorporates Section 401(a)(9) by reference and the plan is not allowing required minimum distributions for 2009 since the WRERA change will just flow through due to the incorporation by reference.

(b) An amendment is required if the Plan, outside of required minimum distributions, only allows lump sum distributions and wants to allow participants to take a partial distribution during 2009 even though a required minimum distribution is not allowed as a result of WRERA. An amendment is required since otherwise no provision of the plan allows the participant to take a partial distribution. The response is the same whether or not the plan incorporates Section 401(a)(9) by reference.

(c) An amendment is required if the plan spells out the Section 401(a)(9) provisions (not by incorporation) and the plan wants to suspend required minimum distributions for 2009 since otherwise the terms of plan would be violated if distributions are not made.

(d) An amendment is required where the plan wants to offer a participant a choice as to whether to suspend required minimum distributions for 2009 for the plan terms to be consistent with administration.

Any amendment resulting from the WRERA provision eliminating the required minimum distribution requirement for 2009 will not be required until the end of the 2011 plan year because any of the above amendments relate to the WRERA change and are only occurring to address the change and therefore should be subject to the WRERA remedial amendment period.

IRS Response: The Service representative indicated that this is a significant issue. The Service is aware that there is a general amendment delay under WRERA until the end of the 2011 plan year. The Service indicated that they expect to address this issue soon in formal published guidance, but the Service representatives cautioned that the formal published guidance will not tell plan sponsors how to interpret their plans.

11. § 401(k) – Contingent Benefit Rule

Treasury Regulation Section 1.401(k)-1(e)(6) addresses other benefits not contingent on elective contributions. Treasury Regulation Section 1.401(k)-1(e)(6)(iii) provides, in part, that “[d]eferred compensation under a nonqualified plan of deferred compensation that is dependent on an employee’s having made the maximum elective deferrals under Section 402(g) or the maximum elective contributions permitted under the terms of the plan also is not treated as contingent.” Do the maximum elective deferrals referred to in the foregoing sentence include catch-up contributions under Section 414(v) of the Code?

Proposed Response: No, catch-up contributions are not part of the maximum elective deferrals under Section 402(g) for purposes of Treasury Regulation Section 1.401(k)-1(e)(6)(iii). When the

above quoted identical language from Section 1.401(k)-1(e)(6)(iii) was included in the 401(k) regulations in 1991 under Section 1.401(k)-1(e)(6)(iv), catch-up contributions did not exist. When the 401(k) regulations were revised effective in 2006, the language was continued in the same form as in the prior regulations, with no statement regarding the status of catch-up contributions. While Section 402(g)(1)(C) of the Code refers to catch-up contributions, it does not set the maximum permissible amount of catch-up contributions the maximum elective deferral limit for catch-up contributions is set forth in Section 414(v) of the Code. The normal reading of a reference to Section 402(g) is that it places a maximum limit on regular elective deferrals provided for in that Section. This position is supported by Treasury Regulation Section 1.414(v)-1(h), Example 5(ii), which makes it clear that the Section 402(g) limit refers to those elective deferrals other than catch-up contributions. In addition, the proposed regulations under Section 409A, in addressing nonqualified deferred compensation plans linked to qualified plans, referenced the elective deferral limits of Section 402(g). The preamble to the final Section 409A regulations states that the reference to Section 402(g) is expanded to reference Sections 402(g)(1)(A),(B) and (C) in order to “clarify that the section 402(g) dollar limits are increased by the limit on catch-up contributions under section 414(v)...” This further supports the normal reading given to a reference to Section 402(g). Finally, including catch-up contributions for purposes of the contingent benefit exception creates discrimination against employees who are older and requires them to make contributions not required from younger employees in order to receive contributions to the non-qualified plan. If catch-up contributions are taken into account for purposes of the contributions that otherwise are being made to the nonqualified plan, it would be easy to provide a requirement in the regulations that those contributions be taken into account. But, in the absence of such contributions being taken into consideration, catch-up contributions should not be included under the contingent benefit rule exception.

IRS Response: The Service representative disagrees with the proposed response. The Service representative believes that Section 402(g) contains the limit on the exclusion of elective deferrals and catch up contributions are included pursuant to Section 402(g)(1)(C) of the Code.

12. § 401(k) – Deferrals on Imputed Income

If a plan defines compensation for purposes of plan benefits as W-2 compensation, and the employee receives employer provided group term life insurance coverage in excess of \$50,000 over which the employee has no election to decline coverage and take cash instead, is the employer required to calculate deferrals and deduct deferrals from other cash income of the employee based on the taxable imputed income reported on the employee’s Form W-2 that results from the excess group term life insurance coverage?

Proposed Response: No. Imputed taxable income that results from excess group term life insurance coverage over which the employee had no election between taxable coverage and deferrals to the plan and over which the employee also had no election to take cash instead of the excess group term life insurance coverage does not satisfy the requirement of Treasury Regulation Section 1.401(k)-1(e)(2)(i) because there is no cash option under the arrangement. As a result, taking deferrals based on the imputed income does not qualify as amounts over which an employee can make a cash or deferred election under Section 401(k). The fact that the employee has no election to take cash instead of the deferral prevents this type of income from being the type of income to which a deferral election may apply. This is also consistent with the Service’s conclusion in Private Letter Ruling 200247050 where the Service ruled that the choice between unused sick leave and a contribution to the qualified plan did not constitute a cash or deferred election because the employee did not have the option to receive additional cash or any other taxable benefit in lieu of the additional contribution to the plan.

IRS Response: The Service representative disagrees with the proposed response. The proposed answer cites to the Section 401(k) regulations which provide that elective deferrals may only be made from cash. The Service representative indicated that there is a distinction between the compensation to which a deferral election is applied and the compensation from which the elective deferrals actually come out. Because the value of group term life insurance is included in compensation, it must be taken into account in applying the employee's deferral election. For example, if an employee elects to defer 10% of compensation and the employee has \$45,000 of cash compensation and \$5,000 of taxable group term life insurance, then \$5,000 must be deferred into the plan. Since the \$5,000 deferral amount cannot be taken from the imputed income from the group term life insurance, the elective deferrals must be taken from cash compensation. The group term life insurance cannot be disregarded for purposes of determining the amount of an employee's compensation unless the plan was specifically drafted to provide that the group term life insurance is excluded from the plan's definition of compensation.

13. § 401(k) – Reduction of Safe Harbor Contributions

An employer sponsors a Section 401(k) plan and has elected to comply with the Section 401(k) safe harbor requirements of Treasury Regulation Section 1.401(k)-3. The employer provides a notice to eligible employees consistent with the content and timing requirements of Treasury Regulation Section 1.401(k)-3(d) indicating that it will provide a 5% qualified nonelective contribution to the plan. The notice was *not* a contingent notice under Treasury Regulation Section 1.401(k)-3(f)(2).

During the plan year, the employer desires to reduce the qualified nonelective contribution from 5% to 3% for the remainder of the plan year. In other words, the employer still desires to provide the required nonelective contribution of 3% and still desires to utilize the safe harbor rules; however, the employer no longer desires to provide a more generous contribution than required under the safe harbor rules.

If the employer were to provide a new notice to eligible employees stating that beginning in 30 days, and for the remainder of the plan year, the qualified nonelective contribution will be 3% of compensation eligible employees earn for the remainder of the plan year (with the employer still making a contribution based on 5% of compensation eligible employees earned prior to the date which is 30 days after the new notice is provided), can the employer still utilize the safe harbor rules without jeopardizing the plan's tax-qualified status?

Proposed Response: Yes. The employer will still be providing the safe harbor required minimum 3% qualified nonelective contribution. Generally speaking, applicable Code requirements allow an employer mid-year to prospectively amend a plan document to decrease a nondiscretionary profit sharing contribution with applicable notices to affected employees, even though employees may have previously received a summary plan description stating what the nondiscretionary profit sharing contribution will be for the year. The proposed course of action is analogous.

Further, Treasury Regulation Section 1.401(k)-3 allows employers flexibility with regard to (1) reducing or suspending a safe harbor matching contribution, and more significantly (2) providing a contingent notice stating the employer may provide a qualified nonelective contribution for the upcoming plan year. In the proposed scenario, the employer ultimately seeks to accomplish the same result which the regulations currently allow an employer to do (under the contingent notice situation) – modify its contribution upon providing additional notice to eligible employees.

IRS Response: The Service representative disagrees with the proposed response. The regulations do not permit this reduction. The plan implemented a safe harbor formula and the employer must provide the contribution based on the notice provided to employees. In this case, the employer must continue to make the 5% contribution. The Service representative expects to issue guidance on this scenario soon.

14. § 401(k) – Reduction of “Enhanced” Safe Harbor Matching Contribution

Employer X maintains a 401(k) plan that provides for safe harbor matching contributions pursuant to Section 401(k)(12) of the Code. Both highly compensated and non-highly compensated employees receive a safe harbor matching contribution under an enhanced matching formula pursuant to Treasury Regulation Section 1.401(k)-3(c)(3). Treasury Regulation Section 1.401(k)-3(g) provides that a plan that provides for safe harbor matching contributions may be amended during a plan year to reduce or suspend safe harbor matching contributions provided, in part, that the plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in Treasury Regulation Section 1.401(k)-2(a)(2)(ii).

Employer X wishes to amend its 401(k) plan to reduce the “enhanced” safe harbor matching contribution to a safe harbor matching contribution under the basic matching formula pursuant to Treasury Regulation Section 1.401(k)-3(c)(2). Employer X does not wish to satisfy the ADP test for the entire plan year in which the reduction occurs. Alternatively, Employer X wishes to amend its 401(k) plan to eliminate the “enhanced” safe harbor matching contribution for highly compensated employees only. Again, Employer X does not wish to satisfy the ADP test for the entire plan year in which the suspension occurs. May Employer X avoid satisfying the ADP test for the entire plan year in which the reduction or suspension occurs under either proposed amendment?

Proposed Response: Yes. Treasury Regulation Section 1.401(k)-3(g) refers to a reduction of safe harbor matching contributions and does not distinguish between an “enhanced” safe harbor matching contribution and a “basic” safe harbor matching contribution. Because Employer X wishes to reduce an “enhanced” safe harbor matching contribution to an amount not below the “basic” safe harbor matching contribution, such a reduction is not contemplated under Treasury Regulation Section 1.401(k)-3(g). Further, Treasury Regulation 1.401(k)-3(c) defines a safe harbor contribution made on behalf of non-highly compensated employees. A matching contribution made to highly compensated employees is not within the scope of Treasury Regulation Section 1.401(k)-3. Therefore, suspension of such safe harbor matching contribution to highly compensated employees is not contemplated under Treasury Regulation Section 1.401(k)-3(g).

IRS Response: The Service representative disagrees with the proposed response. If the plan sponsor elects to reduce the safe harbor matching contribution, then the plan sponsor must follow Treasury Regulation Section 1.401(k)-3(g) on the procedure for reducing or suspending safe harbor matching contributions.

15. § 401(k) – Timing of Amendment Changing to Prior Year Testing Method

Company X maintains a calendar year 401(k) Plan and has conducted ADP/ACP testing under the current year testing method since the prior year method was authorized effective for the 1997 plan year. As a result of the extreme market volatility in the equity markets during the 2008 plan year, an unprecedented number of non-highly compensated employees have ceased to make elective deferrals under the plan. Company X is concerned that this unanticipated occurrence may cause

the plan to fail its ADP/ACP testing for the 2008 plan year. Among other options being considered, Company X would like to amend the plan to provide that ADP/ACP testing will be conducted for the 2008 plan year using the prior year testing method. May Company X amend its 401(k) plan to adopt such change during 2009?

Proposed Response: Yes. Since the categorization of amendments as discretionary or interim is limited by the official guidance to recent legislative changes, and the testing method was enacted into law in 1997, an amendment to change the testing method from the current year method to the prior year amendment is neither a discretionary nor an interim amendment. Therefore, the amendment can be adopted no later than the March 15 of the plan year following the plan year in which the plan is being tested so long as the amendment satisfies the conditions described in Treasury Regulation Section 1.401(k)-2(c)(1) and (2).

IRS Response: The Service representative disagrees with the proposed response. The plan must be amended by the end of the 2008 plan year to implement the prior year testing method. This is a discretionary amendment, therefore, it must be completed by the end of the plan year.

16. § 403(b) – Entry Dates for Elective Deferrals

Are entry dates permissible for Section 403(b) elective deferrals?

Proposed Response: Yes. If the plan is subject to the universal availability requirements, in order to meet the “effective opportunity” requirements under Treasury Regulation Section 1.403(b)-5(b)(2), the plan must have an entry date “at least once during each plan year” where employees have sufficient time and notice to make an election. This answer either assumes the plan is not subject to ERISA or ignores any ERISA requirements that may apply.

IRS Response: The plan in this question is not subject to ERISA. The Service representative agrees with the proposed response that the plan must have an entry date at least once during each plan year. If the plan is subject to the universal availability requirements under the Section 403(b) regulations, in order for the plan to meet the effective opportunity requirements under the Section 403(b) regulations, the plan must have an entry date at least once during each plan year where employees have time and notice to make the election.

17. § 403(b) – Exclusion of Part-Time Employees

Under the universal availability rule of Section 403(b)(12), all employees (with limited exceptions) must be allowed to make contributions pursuant to salary reduction agreements to a Section 403(b) plan. The statute provides an exception for employees who normally work fewer than 20 hours per week, subject to conditions applicable under Section 410(b)(4) of the Code.

Treasury Regulation Section 1.403(b)-5(b)(4)(ii) repeats this permissible exclusion. Treasury Regulation Section 1.403(b)-5(b)(4)(iii)(B) provides a two-part test for plans that wish to utilize this exclusion. Under the first part, for the 12-month period beginning on the employment commencement date, the employer must “reasonably” expect the employee to work fewer than 1,000 hours of service and under the second part, for each plan year after that, the employee must in fact work fewer than 1,000 hours of service in the preceding 12-month period. That regulation then provides a parenthetical cross reference to Section 202(a)(1) of ERISA and the regulations under Section 410(a) “with respect to plans that are subject to Title I of ERISA.”

Some commentators, as well as some large vendors of Section 403(b) plans, have interpreted the parenthetical cross reference to mean that only plans not subject to Title I of ERISA (such as governmental plans) can utilize the part-time exclusion outlined in the statute and in the regulations. However, Section 410(a) explicitly permits the exclusion of employees who work fewer than 1,000 hours of service whether the plan is subject to Title I of ERISA or not. The authority for interpreting the parallel provision of ERISA (Section 202(a)) is vested in the Service by reason of Reorganization Plan No. 4.

Can plans that are subject to Title I of ERISA adopt the part-time exclusion in Treasury Regulation Section 1.403(b)-5?

Proposed Response: As long as the Section 403(b) plan mirrors the two-step requirement in Treasury Regulation Section 1.403(b)-5(b)(4)(iii) and excludes all employees who fall within those parameters, the plan will be able to satisfy the universal eligibility test even if the plan is subject to Title I of ERISA. Neither Section 202(a) of ERISA nor Section 410(a) prohibit the exclusion of employees who work fewer than 1,000 hours of service as described in the foregoing regulation.

IRS Response: The Service representative agrees that this exclusion is permissible. In this fact pattern, the Section 403(b) plan is subject to Title I of ERISA. If a Section 403(b) plan is subject to Title I of ERISA and wants to use this exclusion for part-time employees, the plan must independently satisfy the requirements of the 403(b) regulations and the requirements of ERISA at the same time. For purposes of ERISA, there can be a 1,000 hour of service requirement in the initial eligibility computation period for those who are reasonably expected to be below the 20-hour per week level. In such situations, the employee would be eligible at the end of the 12-month period if the employee satisfied the 1,000 hours of service requirement. If the employee does not satisfy the 1,000 hours of service requirement, the employer must keep testing using the normal ERISA rules for the future, which is the same rule as in the Section 403(b) regulations.

The Service tried to accommodate this situation in the draft plan language in the list of required modifications (LRMs) that were recently published. In LRM 13, there is a box that may be checked for part-time employee exclusions that is intended to work for this purpose. The Service representative emphasized that if practitioners do not think this works or if it can be improved, the Service would like comments on this issue.

18. § 409A – Acceleration of Payment

A nonqualified deferred compensation plan subject to Section 409A provides for a distribution at age 65 or, if earlier, upon an involuntary separation from service. If the separation is voluntary, payment is made at age 65 (*i.e.*, on the original fixed payment date). Does such a provision (accelerating payment upon only a subset of an otherwise permissible payment event) comply with Section 409A?

Proposed Response: Yes. Section 409A permits distributions to be made upon the earlier of one or more permissible payment events, such as the first to occur of a date certain (*e.g.*, age 65) or a separation from service. When a separation from service is a payment event, there is no requirement that every possible separation from service is a payment event. Because payment could be made before age 65 upon any separation from service (whether voluntary or involuntary), it likewise should be permissible to permit an earlier distribution upon a subset of the permissible payment event (*e.g.*, upon an involuntary but not voluntary separation from service).

IRS Response: The Service representative agrees with the proposed answer as long as whether there has been an involuntary separation from service is objectively determinable and non-discretionary.

19. § 409A – Acceleration of Payment

The Section 409A regulations allow a plan sponsor to accelerate payment of nonqualified benefits *if* the payment is made pursuant to a permitted termination and liquidation of the plan. A termination and liquidation is permitted under the Section 409A rules if it does not occur “proximate to a downturn in the financial health” of the plan sponsor. There has been no formal guidance from the Service to date on how we should determine what constitutes a “downturn in the financial health” of the plan sponsor. Would a plan sponsor caught up in the current general economic downturn be regarded as experiencing a “downturn in the financial health” for purposes of this restriction? Or would it take something more, like a pending bankruptcy filing or other formal indications of insolvency?

Proposed Response: Poor economic conditions generally, without more, do not constitute a “downturn in the financial health” of a nonqualified plan sponsor for purposes of the Section 409A regulations, even if they prompt the sponsor to do some belt-tightening, such as eliminating executive deferred compensation plans in order to save money. But if the sponsor has objective knowledge that insolvency is imminent (*e.g.*, it has received legal advice to file for bankruptcy protection), this could bar it from making payments pursuant to a termination and liquidation of the deferred compensation plan.

IRS Response: The Service representative indicated that a downturn in the financial health of the plan sponsor is a facts and circumstances determination, but insolvency or bankruptcy does not need to be imminent to be considered a downturn in the financial health of the plan sponsor.

20. § 409A – Application to Property Versus Services

Where the arrangement is for the acquisition of an interest in property that is to be created by the service provider, is the arrangement characterized as an agreement for property or an agreement for services?

Proposed Response: Where the principal purpose of the arrangement is the acquisition of property (or an interest in property), the arrangement will be characterized as relating to property and Section 409A will not be applicable. The fact that the property is to be created and that the creation of the property involves services is irrelevant. For example, where a service recipient engages a service provider to write a book, song, software program, or similar item, and the service recipient acquires the ownership of or distribution rights to such property, the arrangement is either a sale or a license, respectively, and not an agreement for the services of the service provider. Thus, Section 409A would not apply to such arrangements.

IRS Response: The Service representative disagrees with the proposed response. The standard for exclusion from Section 409A is not whether the arrangement relates to property. If the arrangement involves a current transfer of property subject to Section 83, it is not subject to Section 409A. If the transaction involves the sale or acquisition of property where the amount realized is not taxed as compensation, the transaction is not subject to Section 409A. However, where the arrangement involves a legally binding right to a payment in the future, including a payment that will be made in property, the arrangement generally will be subject to Section 409A, unless an exception, such as the short-term deferral exception, to Section 409A applies.

21. § 409A – Cancellation of Deferral Election

Question A: Under a nonqualified deferred compensation plan subject to Section 409A of the Code, Participant A makes an irrevocable election in December 2008 to defer a specified percentage of a 2009 performance bonus that is normally paid in February 2010. Participant A's deferral election specifies that the deferred amount of the 2009 performance bonus shall be paid in 15 annual installments commencing upon the first day of the month immediately following Participant A's separation from service (as defined by Section 409A) from the sponsoring company. Participant A is not a specified employee of the sponsoring company. Participant A separates from service with the sponsoring company in August 2009. Based on the terms of the sponsoring company's performance bonus, Participant A is entitled to a pro rata percentage of the 2009 performance bonus, to be paid in February 2010. Without violating the prohibition against acceleration under Treasury Regulation Section 1.409A-3(j), may the sponsoring company's nonqualified deferred compensation plan provide that Participant A's deferral election is disregarded with respect to the 2009 performance bonus paid in February 2010 as a result of Participant A's separation from service prior to the bonus payment date?

Question B: If disregarding Participant A's deferral election is treated as a violation of the prohibition against acceleration under Treasury Regulation Section 1.409A-3(j), then will the payments be treated as made upon the designated payment date under Treasury Regulation Section 1.409A-3(d) if the sponsoring company: (a) pays the first installment on the bonus payment date in February 2010; and (b) pays the remaining 14 annual installments commencing September 1, 2010?

Question C: If disregarding Participant A's deferral election is treated as a violation of the prohibition against acceleration under Treasury Regulation Section 1.409A-3(j), and the first installment is not treated as made upon the designated payment date under Treasury Regulation Section 1.409A-3(d) if such payment is made on the bonus payment date, then may the sponsoring company treat the first installment due on September 1, 2009 as zero (because Participant A's account balance on such date is zero) and pay the full deferred amount over the remaining 14 annual installments commencing September 1, 2010?

Proposed Response A: Yes, the sponsoring company's nonqualified deferred compensation plan may provide that a participant's deferral election is disregarded with respect to compensation paid subsequent to such participant's separation from service from the sponsoring company. Similar to cancelling a deferral election in the event of an unforeseeable emergency or a disability, cancelling Participant A's deferral election upon a separation from service is consistent with Congress's intent to provide limited "exceptions to the prohibition on accelerated distributions, such as when the accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective." (*See* H.R. Conf. Rep. No. 108-755, at 731 (2004)). Similar to a disability and an unforeseeable emergency, a separation from service is a permissible payment event under Section 409A, and such payment is not elective because the nonqualified deferred compensation plan requires the cancellation of the deferral election. Cancelling Participant A's deferral election upon a separation from service also does not raise the same issue with uncertainty and lack of a clear standard that was addressed in Section VIII.I of the Preamble to the Final Regulations to Section 409A with respect to cancelling a deferral election due to a transfer to a position that is not eligible to participate in a nonqualified deferred compensation plan.

IRS Response A: The Service representative disagrees with the proposed answer. There is no regulatory exception that would allow the service recipient to accelerate payments due to a separation from service where the plan does not provide for such a payment date or, as in this case,

where the plan provides for a different type of payment upon separation from service. It generally would be permissible, however, for the plan to provide for a different form of payment. For example, the plan could provide for a lump sum payment during 2009 in the event that the separation from service occurs before a specified date.

Proposed Response B: If the Service disagrees with Proposed Response A, then the sponsoring company must withhold the specified percentage from Participant A's 2009 performance bonus pursuant to Participant A's deferral election. Treasury Regulation Section 1.409A-3(d) provides that if the calculation of a payment is not administratively practicable due to events beyond a participant's control, then the payment will be treated as timely made if the payment is made during the first taxable year of the service provider in which the calculation of the amount of the payment is administratively practicable. Because Participant A elected to have his or her 2009 performance bonus paid in 15 annual installments commencing on first day of the month immediately following his or her separation from service, and such date (September 1, 2009) occurred prior to the date that the 2009 performance bonus was paid, the sponsoring company is in compliance with Treasury Regulation Section 1.409A-3(d) if it pays the amount of first installment of the 2009 performance bonus to Participant A on bonus payment date in February 2010, and pays the remaining 14 annual installments on September 1 of each year beginning in 2010.

IRS Response B: The determination of whether making the payment would be administratively practicable is a facts and circumstances test. Accordingly, the Service representative declined to give a definitive answer.

Proposed Response C: If the Service disagrees with Proposed Responses A and B, then the sponsoring company is in compliance with Treasury Regulation Section 1.409A-3(d) if it treats the first installment due on September 1, 2009 as zero (*i.e.*, 1/15th of Participant A's account balance on such date, which is zero) and pays the full deferred amount of the 2009 performance bonus over the remaining 14 annual installments on September 1 of each year beginning in 2010.

IRS Response C: The Service representative indicated there is not a definitive answer to this question. In this question, the analysis is that the participant's balance is zero on the September 1, 2009 payment date so the participant is not entitled to a payment. Whether the balance is zero is a facts and circumstances test. The Service representative again indicated that it is permissible to specify a different payment schedule if a separation from service occurs before a specified date.

22. § 409A – Change in Form of Payment

A nonqualified deferred compensation plan subject to Section 409A provides for payment of the deferred benefits in cash. The service recipient and/or service provider want to provide (after the deadline for making initial deferral elections) that payment will be made instead in restricted stock. Can this election be made without regard to subsequent deferral election timing rules?

Proposed Response: Yes. Treasury Regulation Section 1.409A-1(b)(6)(i) provides that the transfer of restricted property pursuant to a plan does not constitute a deferral of compensation under 409A. Further, the preamble states that an election between compensation alternatives, neither of which provides for a deferral of compensation under Section 409A, such as a choice between a payment in cash constituting a short-term deferral on the one hand and a payment in restricted stock on the other, is not subject to the Section 409A election timing rules. Thus, an election to receive payment of a deferred amount in restricted stock does not constitute a subsequent deferral of compensation and is therefore not subject to the rules governing subsequent deferral elections (though such an election may be subject to other constraints imposed by Section

83 or the constructive receipt or economic benefit doctrines). The fact that the change in the medium of payment (from cash to restricted stock) also changes the timing of income inclusion (from payment of the cash to the later vesting of the restricted stock) does not alter this analysis.

IRS Response: The Service representative indicated that there is not an answer to this question and that this is an issue that is under study by the IRS and Treasury.

23. § 409A – Change in Time of Distribution

A nonqualified deferred compensation plan subject to Section 409A provides for a distribution on the date the service provider would attain age 65. After the period for making initial deferral elections has expired, the service provider elects to have distributions made upon the earlier of death or the date he attains age 65. The service provider dies within one year of making the election. Is the distribution payable upon death or the date the service provider would have attained age 65?

Proposed Response: The distribution is payable upon death. Treasury Regulation Section 1.409A-3(j)(2) provides that the addition of death (or disability or unforeseeable emergency) as a potentially earlier payment date is a permissible acceleration under Section 409A. Accordingly, there is no requirement for such an election change to comply with the subsequent deferral rules under Section 409A (including its requirement that redeferral elections not take effect for 12 months), notwithstanding that the subsequent deferral rules would apply if death were added as a potentially *later* payment date.

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

24. § 409A – Contingent Compensation

How do the rules with respect to substantial risk of forfeiture and short-term deferral apply to compensation that is contingent upon the achievement of some objective criteria (such as net profits from the exploitation of some intangible) which compensation would be paid over a period of years where, once that criteria is achieved, the obligation to pay and amount of payment are measured periodically (*e.g.*, each calendar year quarter, the service recipient would determine whether there are still net profits that would obligate it to make a payment and, if so, the amount of such payment)?

Proposed Response: Where the obligation to pay deferred compensation is contingent upon some objective criteria which is measured periodically and the amount, if any, to be paid is not reasonably ascertainable until such measurement date, there is a substantial risk of forfeiture until: (a) it is determined that the contingency (including an ongoing contingency) has been achieved and the service recipient is obligated to make a payment; and (b) the amount of contingent deferred compensation to be paid is able to be computed with reasonable accuracy. Once that substantial risk of forfeiture lapses, the payment must be made within the applicable short-term deferral period in order for the short-term deferral rules of Treasury Regulation Section 1.409A-1(b)(4) to apply.

IRS Response: The Service representative disagrees with the proposed response and indicated that it is a facts and circumstances test as to whether a particular situation constitutes a substantial risk of forfeiture.

25. § 409A – Mid-year Changes in Compensation

Below are four fact patterns intended to illustrate potential Section 409A issues if a service provider's compensation "mix" is changed mid-year.

Case 1: Assume employee/service provider makes a valid election in December 2009 to defer 10% of his or her 2010 base salary ("Salary") to a deferred compensation plan that is subject to 409A ("Deferred Compensation Plan"). Employer/service recipient normally makes annual base salary adjustments in April.

In April 2010, Employer increases executive's Salary by 5% effective May 1, 2010. Does this create a problem under Section 409A because the change in Salary impacts the deferral amounts? What if employer decreases executive's Salary by 5%?

Proposed Response to Case 1: Neither an increase or decrease in Salary is problematic unless facts and circumstances clearly show that the Salary change is part of a scheme to change the time and form of payment of what would otherwise have been nonqualified deferred compensation (*e.g.*, there is collusion by employer and employee to defeat Section 409A limitations).

IRS Response to Case 1: A bona fide increase or decrease in salary where there is no accompanying increase or decrease in other forms of compensation should not raise issues provided that the deferral election is applied to the increased or decreased salary.

Case 2: Assume the same facts as in Case 1 except that employee's total compensation as of January 1, 2010 is comprised of 40% Salary, 30% discretionary bonus (not performance-based), and 30% long-term incentive plan ("LTIP") award that is excluded from Section 409A under the short-term deferral exclusion. Employee makes a valid election in December 2009 to defer 10% of 2010 Salary only to the Deferred Compensation Plan.

In March 2010, employer decides to change employee's compensation mix to 20% Salary, 40% discretionary bonus (not performance-based) and 40% LTIP award that fits within the short-term deferral exception, effective April 1, 2010. The "value" of the total compensation package for the employee does not change by more than a de minimis amount. Does this create a problem under Section 409A due to the reduction in the total amount that would have been deferred prior to the change in compensation?

Proposed Response to Case 2: None of the compensation adjustments is problematic unless the facts and circumstances show that the compensation package change is a collusive scheme to change the time and form of payment of what would otherwise have been nonqualified deferred compensation and avoid the limitations of Section 409A.

Case 3: Assume the same facts as Case 2 except that employee makes a valid election in December 2009 to defer 10% of 2010 Salary and discretionary bonus to the Deferred Compensation Plan. Does the answer change in Case 2?

Proposed Response to Case 3: No. The answer is the same as for Case 2.

Case 4: Assume the same facts as in Case 1, that is that the employee makes a valid election in December 2009 to defer 10% of 2010 Salary to the Deferred Compensation Plan, except that employer does not adjust employee's salary in April 2010. Employee's 2010 Salary is \$100,000, so employee has elected to have \$10,000 of Salary deferred into the Deferred Compensation Plan.

In June 2010, employee elects to receive in lieu of his or her remaining Salary for 2010 (assume \$50,000) compensation in the form of non-qualified stock options (with FMV strike price as of date of grant). Does this create a problem under Section 409A because employee has effectively changed his or her deferral amount?

Proposed Response to Case 4: The general rule is that the Salary that would have been paid in cash can be “changed” to options and neither element is subject to Section 409A. However, if the “option for Salary” election results in a decrease in the amount of Salary deferred into the Deferred Compensation Plan there will be an impermissible change in the time and form of payment of such amounts. However, if the same amount is deferred into the Deferred Compensation Plan, in this case \$10,000, this does not create a problem under Section 409A.

IRS Response to Cases 2-4: The answer in Cases 2-4 depends on the facts and circumstances, but there is not a definitive answer. One issue is whether the amount to which the deferral election applied was objectively determinable and whether the deferral election was irrevocable. Evidence of collusion is not necessary for the determination that the deferral election was in effect revocable at the discretion of the employer through reconfiguration of the compensation package.

26. § 409A – Open-Ended Milestones for Payment of Service Compensation

How do the rules with respect to a substantial risk of forfeiture and short-term deferral apply where the event that triggers the obligation to make a payment of service compensation is open-ended and/or within the control of the service provider (*e.g.*, payment is due upon completion or delivery of the service)?

Proposed Response: Where the service provider must perform specified services in order to receive compensation (*e.g.*, a payment is due upon the achievement of a certain “milestone” such as completion or delivery of the service), there is a substantial risk of forfeiture until that milestone is achieved. The fact that there is no defined performance period or specific date by which the service must be completed does not alter this conclusion. The substantial risk of forfeiture will lapse when the milestone is achieved (*i.e.*, the services are performed), provided that the payment is made within the applicable short-term deferral period, the arrangement will be exempt from Section 409A under the short-term deferral rules of Treasury Regulation Section 1.409A-1(b)(4).

IRS Response: The Service representative indicated that there is not a definitive answer to either this question or Question 27. In this question, whether a particular service condition requires substantial services and whether those services are a substantial risk of forfeiture depends on the facts and circumstances. Likewise, in Question 27, whether the services are a substantial risk of forfeiture also is a facts and circumstances determination.

27. § 409A – Open-Ended Milestones for Timing of Services

How are the rules with respect to a substantial risk of forfeiture and short-term deferral applied where the service recipient has annual production schedules or product cycles that may cause it to add a delivery schedule to an arrangement that originally was open-ended as to the timing of the provision of the services? For example, a service provider is engaged to deliver a new product concept with no deadline for delivery of that new concept. Payment is due upon delivery and no payment is due if the service provider does not deliver the new concept. However, due to the service recipient’s product cycle, its need for delivery of the new product concept is either accelerated (*e.g.*, because other components for the product are available earlier than expected) or delayed (*e.g.*, because the sales and distribution network for the current product cycle is full). The

change in the service recipient's timing needs for the new product concept may cause it to request that the new product concept be delivered by a certain date (where no delivery date has previously existed) or cause the service recipient to inform the service provider that no new product concepts will be accepted until the beginning of the next product cycle. The change to the timing of the delivery of the new product concept will change the delivery of the services (the triggering event for the payment obligation) and, therefore, the timing of the payment.

Proposed Response: The substantial risk of forfeiture in this arrangement is the performance of the service – that is, the delivery of the new product concept. Since that service must continue to be performed in order for the payment to be made (though earlier or later at the request of the service recipient), a change in the timing of the milestone event will not negate the existence of that risk. Thus, the substantial risk of forfeiture will lapse when the milestone event occurs, and provided that the payment is made within the applicable short-term deferral period, the arrangement will be exempt from Section 409A under the short-term deferral rules of Treasury Regulation Section 1.409A-1(b)(4).

IRS Response: The Service representative indicated that there is not a definitive answer to either this question or Question 26. In this question, whether the services performed are a substantial risk of forfeiture depends on the circumstances. Likewise, in Question 26, whether a particular service condition requires substantial services and whether those services are a substantial risk of forfeiture also is a facts and circumstances determination.

28. § 409A – Payment on Separation from Service

Treasury Regulation Section 1.409A-3(b) provides that a plan may provide that a payment “is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs, but only if the designated period both begins and ends within one taxable year of the service provider or the designated period is not more than 90 days and the service provider does not have a right to designate the taxable year of the payment...” Will a plan that provides for a payment within 90 days following the quarterly valuation date next following the employee's separation from service comply with the requirements of Treasury Regulation 1.409A-3(b)?

Proposed Response: Yes. Treasury Regulation Section 1.409A-3(b) requires payment within 90 days of a designated period. Under these facts, the 90-day designated period is the period following the quarterly valuation date following the employee's separation from service.

IRS Response: To the extent that a valuation date could be changed by one or both parties, then this may not be an objectively determinable and non-discretionary period. It is permissible, however, to provide that the payment would be made within 90 days following the end of the calendar quarter in which the separation from service occurs.

29. § 409A – Prefunding of Nonqualified Deferred Compensation Plans

Do Section 409A(b)(3)'s restrictions on prefunding nonqualified deferred compensation of covered employees during a restricted period with respect to qualified single-employer defined benefit plan apply to the CEO of a non-public entity? This question arises because Section 409A(b)(3)(D)(ii) defines covered employee as including individuals described in Section 162(m)(3). Section 162(m)(3)(A) provides: “For purposes of this subsection, the term ‘covered employee’ means any employee of the taxpayer if ... as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity.” While Section

162(m) only applies to public companies, this text could be read as subjecting CEOs of all entities, including privately held companies and not-for-profit entities, to the prefunding restriction in Section 409A(b)(3).

Proposed Response: Section 409A(b)(3)'s restrictions on prefunding nonqualified deferred compensation of covered employees during a restricted period with respect to qualified single-employer defined benefit plan apply only to covered employees of public companies.

IRS Response: The Service representative indicated that there is not an answer on this question and that it is an issue that is under study.

30. § 409A – Reduction in Profits Interest

Pursuant to a contract, the service provider has a percentage interest in back-end profits, if any, from the sale or exploitation of property which will be created in part by the service provider's activities. In the contract, the percentage interest may be reduced (but not below a specified floor) by back-end profits participations transferred by the service recipient to other parties whose services are used in creation of the property. Assuming that the back-end profit participation would otherwise constitute deferred compensation for purposes of Section 409A, what is the effect of the contract provision and a reduction in the service provider's percentage under Section 409A?

Proposed Response: The contract provides for a discretionary unilateral reduction in the service provider's compensation by the service recipient, but not below a specified amount. That discretion is not exercisable only upon a condition. Since the exercise of the discretion reduces compensation to the service provider, the discretion to reduce the compensation has substantive significance. Therefore, pursuant to Treasury Regulation Section 1.409A-1(b)(1) the service provider does not have a legally binding right to the back-end profit participation in excess of the defined "guaranteed" floor. Further, the reduction in the amount of compensation is not a transfer or assignment that would constitute a "substitution" pursuant to Treasury Regulation Section 1.409A-3(f).

IRS Response: The Service representative indicated that there is not a definitive answer to this question. Whether the service recipient's discretion to reduce the payment has substantive significance is determined on the basis of all of the facts and circumstances. Substantive significance is not necessarily met just because the exercise of the discretion would cause a reduction in the compensation. In addition, whether a substitution occurs is based on all the facts and circumstances, provided that the mere exercise of the discretion to reduce the compensation would not alone result in a substitute payment.

31. § 409A – Severance Payments

Assume under an employment agreement an executive is entitled to a severance payment if he is involuntarily terminated without cause either within 120 days prior to a change in control or within 12 months following a change in control. The change in control definition does not conform to the Section 409A change in control definition. If the severance payment is to be paid within 65 days following the later of the executive's involuntary termination or the occurrence of the change in control, will the payment meet either the short-term deferral or separation pay exception under Section 409A, in which event the 6-month delay for payments to a "specified employee" would not apply?

Proposed Response: Because in this example the severance benefit can be based on the executive's involuntary termination as much as 120 days prior to the later occurrence of a change in control, it would seem that the agreement provides for a deferred payment and therefore the short-term deferral exception would not apply (even if under certain fact patterns the payment is actually made within 2½ months following the year in which the executive is involuntarily terminated). See Treasury Regulation Section 1.409A-1(b)(4)(i)(D). With respect to the application of the separation pay exception in this "double trigger" severance benefit scenario, the conclusion seems less clear. The separation pay exception requires, inter alia, that the separation pay plan provides for separation pay "only upon an involuntary separation from service." Treasury Regulation Section 1.409A-1(b)(9)(iii). The Preamble to the Final Section 409A regulations provides, "This exception [*i.e.*, the separation pay exception] only applies where the payment is available solely due to an involuntary separation from service of the service provider, or the service provider's participation in a window program, and not to a plan providing for a payment upon a voluntary separation from service "or other event." Preamble at Sec. II. J. 2. Does the double trigger severance payment (*i.e.*, requiring the occurrence of a change in control before payment is made) bring into play an "other event" as described in the Preamble? Though the involuntary separation from service is the Section 409A payment trigger event, it is not entirely clear whether the need for a contractually defined change in control causes the payment to run afoul of the "solely due to an involuntary separation from service" requirement. One might argue that a change in control event has sufficient independent business significance so as to overcome any assertion that the required occurrence of a change in control as a condition to payment of a severance benefit in connection with the employee's involuntary separation from service prevents compliance with the "solely due to" requirement. The need for a change in control should not create an opportunity for discretionary abuse, and therefore, the separation pay exception should be available.

IRS Response: The Service representative agrees with the proposed response. Even if the requirement for a change in control constituted a substantial risk of forfeiture, the requirements for a short term deferral are not met. However, since no payment will not be made in any case where the service provider does not have an involuntary separation from service, the separation pay exception can apply in this case.

32. § 409A – Short-Term Deferral Exclusion

If a payment satisfies the short-term deferral exception to Treasury Regulation Section 1.409A-1(b)(4), may the parties subsequently adjust the amount and timing of payments?

Proposed Response: Yes. If the short-term deferral exception applies to the original arrangement, then such arrangement is excluded from Section 409A. The original arrangement may therefore be modified provided that the modified arrangement also qualifies for exception to Section 409A under the short-term deferral rule.

IRS Response: Yes, but other tax doctrines such as constructive receipt continue to apply.

33. § 411 – Shutdown Benefits in a Qualified Plan

In General Counsel Memorandum 39869, the Service concluded that shutdown benefits that are retirement-type benefits may be provided under a qualified plan and that shutdown benefits that are ancillary benefits (*i.e.*, social security supplements) also may be provided under a qualified plan, but shutdown benefits that are layoff or severance type benefits may not be provided in a qualified plan. In General Counsel Memorandum 39869, the Service ruled that retirement-type benefits, but not ancillary benefits, become accrued benefits and therefore are protected under Section 411(d)(6)

of the Code upon the occurrence of the event that triggers the right to the payment of benefits (*i.e.*, the contingent event). In light of Notice 2007-14, does General Counsel Memorandum 39869 still accurately reflect the Service's position?

Proposed Response: Until further guidance is issued, General Counsel Memorandum 39869 still reflects the Service's position.

IRS Response: A General Counsel Memorandum is not the Service's position and it cannot be relied on as reflecting the Service's position. The question of what constitutes a shutdown benefit and whether the shutdown benefit is protected is described in Treasury Regulation Section 1.411(d)-3. The Service analyzed the case law, including the *Bellas* case², and concluded that if a shutdown benefit is a retirement-type benefit, then it is protected under Section 411(d)(6) of the Code. If a shutdown benefit is an ancillary benefit, then it is not protected under Section 411(d)(6) of the Code.

The next question is how to determine whether a benefit is a retirement-type benefit or an ancillary benefit. In the "ancillary benefit" definition in the definition section of Treasury Regulation Section 1.411(d)-3, there is a phrase about "the type of benefit that is permitted in a qualified pension plan." If the plan contains a benefit that would be a retirement-type benefit, but for whatever reason, the benefit is not permitted to be in a qualified plan, it is not protected under Section 411(d)(6). The exact contours of the types of benefits that are permitted to be in a qualified plan, however, are not that clear. Notice 2007-14 solicits comments about the types of benefits that are permitted to be in a qualified plan. To date, the Service has not done anything with the comments that it has received on Notice 2007-14. At some point, the Service representative indicated that the Service will review the comments and provide additional guidance on the definitions of ancillary benefit and retirement-type benefit for purposes of applying the rules under Section 411(d)(6) of the Code.

34. § 411 – Restoration of Forfeited Accounts

Company X sponsors a 401(k) plan which is intended to be a QACA. If a participant elects (or is deemed to have elected) to make 401(k) contributions to the plan, Company X matches such contributions at the following rates: 100% of the participant's 401(k) contributions not in excess of 4% and 50% of the participant's 401(k) contributions between 4 and 6%. Under the plan, any participant with less than 2 years of service is 0% vested in Company X's matching contributions and any participant with at least 2 years of service is 100% vested in Company X's matching contributions. Employee A is hired by Company X, enrolls in the plan and elects to make a 401(k) contribution equal to 5% of his compensation on January 1, 2009. On January 30, 2010, Employee A terminates employment and elects to receive his 401(k) contributions which are paid on February 20, 2010. If Employee A is rehired by X on September 1, 2011, can Employee A repay his 401(k) contributions and have his employer matching contributions restored?

Proposed Response: Yes. According to Treasury Regulations Section 1.401(k)-1(c)(2), even if a participant is 0% in employer nonelective or matching contributions, he is considered to be at least partially vested in such contributions for purposes of the buyback restoration rules of Section 411(a)(7)(C) of the Code.

IRS Response: The Service representative agrees with the proposed response. Since some of this employee's money was vested, this employee would not be a non-vested participant.

² *Bellas v. CBS, Inc.*, 221 F3d. 517 (3d Cir. 2000).

35. § 411 – Subsidized Lump Sum Conditioned on Prompt Election

Participants in a defined benefit plan are eligible for a subsidized immediate lump sum if they terminate employment after age 55 with 15 years of service, *provided* the participant submits completed election forms by the last day of the month in which the termination occurs. (An immediate joint and survivor annuity with the same value also is available under the same conditions.) Participants who are otherwise eligible (based on age and service) but who do not make a timely election may elect to commence an annuity at any time with a full actuarial reduction, but no lump sum or subsidy is available. The plan has always included the “prompt election” requirement and the requirement is clearly communicated to participants in the summary plan description. Is this structure permitted?

Proposed Response: Yes. Under Treasury Regulation Section 1.411(d)-4, Q&A-6, a plan is permitted to condition the availability of a benefit form or early retirement subsidy on the satisfaction of objective conditions that are specifically set forth in the plan.

IRS Response: The proposed response addresses Section 411(d)(6). The Service representative indicated that there is a separate question under Section 411(a)(11), which is whether the plan is avoiding the requirement to obtain consent by having a significant detriment apply to participants who do not choose to commence benefits right now. Whether there is a significant detriment is based on all of the facts and circumstances. The Service representative’s personal view is that this provision is a significant detriment because it forces participants to take their benefits now.

36. § 414(p) – Costs of Processing QDROs

If a sponsor of a defined benefit plan wants to pass on the reasonable cost of processing and administering a QDRO to the participant and the putative alternate payee and, provided that the DOL ultimately determines that such a charge can be assessed outside of the plan, if the plan provides that, in the event the parties fail to pay the charge, the charge will be reduced from the amount otherwise payable under the plan pursuant to the QDRO will such be viewed as an impermissible reduction of the participant’s accrued benefit?

Proposed Response: No, provided that the cost is reasonable and that the parties are given sufficient notice, both in the plan’s summary plan description and in the plan’s QDRO policies and procedures. The imposition of administrative cost in the context of a defined contribution plan has not been viewed as a reduction of a participant’s accrued benefit. *See, e.g.,* Revenue Ruling 2004-10. There is no reason why a different result should be reached in the context of a defined benefit plan particularly where the participant is first given the option to pay the cost using other sources and where the participant and the putative alternate payee are given timely and sufficient notice.

IRS Response: The Service representative disagrees with the proposed response. In a defined benefit plan, expenses cannot be charged to plan participants. Expenses are part of net earnings that can be charged to participants in a defined contribution plan, but in a defined benefit plan, the participant has a right to his benefit. The plan is taking something away from the participant if it does not provide the participant with his entire benefit.

37. § 415 – Administration of Plan to Comply with Section 415 Limits

If a plan is administered such that, due to reasonable errors in estimating compensation, the limits of Section 415 of the Code are regularly exceeded but the excess is timely corrected under the

Employee Plans Compliance Resolution System (EPCRS), is that correction procedure consistent with Section 415 of the Code and with EPCRS?

Proposed Response: Yes. If a plan is administered so as to timely correct failures to satisfy the Section 415 limits of the Code under EPCRS, the excess allocation will be disregarded for purposes of Section 415 of the Code. In addition, so long as the plan sponsor has a favorable determination letter and has established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Code requirements, even multiple corrections for violations of the limitations of Section 415 of the Code in multiple years may be corrected using the EPCRS Self-Correction Program.

IRS Response: The Service representative disagrees with the proposed question. In the proposed question, the plan is being administered so that due to reasonable errors in estimating compensation, the limitations of Section 415 of the Code are regularly exceeded, but are timely corrected under EPCRS. The Service representative indicated that the plan should have practices and procedures in place that are reasonably designed to promote compliance without regard to regularly occurring failures. If the plan has repeated failures to comply with any requirement, not just Section 415, over multiple years, the plan should take steps to modify its practices and procedures to prevent failures from reoccurring. This will be what happens when the plan is submitted under EPCRS and it is especially true in the case of a significant failure. If the question was modified to change the “multiple corrections for violations in multiple years” to a significant failure, the Service representative thinks that the question is more on the right track.

38. § 415 – Correction of Excess Deferrals

The final regulations under Section 415 of the Code do not include the correction methods for excess annual additions that were applicable under Treasury Regulation Section 1.415-6(b)(6), but suggest that the deleted correction methods are generally permitted under the Employee Plans Compliance Resolution System (EPCRS). EPCRS permits correction through the use of the Self-Correction Program for failure to satisfy the Section 415 limits in a defined contribution plan even if the excess did not result from the allocation of forfeitures or a reasonable error in estimating compensation. Was this change intended to broaden the circumstances under which a plan sponsor may self-correct a failure to satisfy the limits of Section 415 of the Code?

Proposed Response: Yes. One of the goals of Revenue Procedure 2008-50 was to expand the scope of the Self-Correction Program, thus encouraging plan sponsors to self-correct plan operational errors, including expanding the circumstances under which a plan sponsor may self-correct a failure to satisfy the limitations of Section 415 of the Code.

IRS Response: The intent was not to broaden the circumstances under which a plan sponsor may self-correct a failure to satisfy the limits of Section 415 of the Code. Revenue Procedure 2008-50 expands the corrections by eliminating the requirement that the error be due to specific reasons, but it imposes the normal EPCRS requirements instead. For example, for self-correction, the plan must have established practices and procedures designed to promote compliance. The timing rules for whether a failure is significant continue to apply. The change was really to use the same uniform general standards that EPCRS applies to all types of failures to a Section 415 failure, not simply to expand the correction for a Section 415 failure. Nothing in EPCRS changes the normal program eligibility requirements for Section 415 failures. This failure was eligible for correction using the Self-Correction Program before the changes in the Section 415 regulations, so by moving the correction methodology out of the regulation does not broaden the plan sponsor’s ability to use the Self-Correction Program.

39. § 415 – Safe Harbor Compensation and Short-term Disability Payments

Can third-party short-term disability payments be included within one of the safe harbor definitions of compensation under Section 415 of the Code?

Proposed Response: Third-party short-term disability payments would not be included within the withholding safe harbor definition pursuant to Treasury Regulation Section 31.3401(a)-1(b)(8)(i)(a). Third-party short-term disability payments would not be included in the W-2 safe harbor since it is only by agreement that the employer would include such amounts in the employee's W-2. However, third-party short-term disability payments would be included as part of the general Section 415 safe harbor definition of compensation as an amount described in Section 105(a) to the extent the amounts are includible in the gross income of the employee.

IRS Response: The Service representative indicated that the analysis of the employment tax treatment of short-term disability benefits in the proposed response could be more precise, however, the Service representative agrees with the last sentence of the proposed response.

40. § 417 – Deadline for Benefit Elections

A defined benefit plan provides terminating participants with retirement packages (qualified joint and survivor annuity explanations with relative value disclosure, election forms, etc.) that use an assumed annuity starting date approximately 60 days in the future, with a clear notation that the assumed annuity starting will be valid only if completed election forms are returned at least 10 days *before* that date. Otherwise, a new package will be provided with a new annuity starting date that is approximately 60 days from the date the new package is provided. In other words, the election forms always “expire” after about 60 days, even though regulations would permit the plan to accept elections as long as 180 days after the date they are provided and still use the originally-scheduled annuity starting date. Is the earlier plan-imposed expiration date permitted, or must the plan accept elections that are submitted within 180 days of the date notice is provided and use the originally-scheduled annuity starting date?

Proposed Response: An earlier plan-imposed election deadline is permitted as long as the deadline is no shorter than 30 days. Treasury Regulation Section 1.417(e)-1(b)(3)(iii) provides that a plan “may” use a look-back annuity starting date, as long as distributions commence within 180 days of a qualified joint and survivor annuity notice that was provided before the annuity starting date. But a plan can provide for an earlier election deadline if it chooses (as long as the period is at least 30 days). A plan might impose an earlier deadline so that, for example, the plan need not concern itself with determining the amount of interest that might be due in the event actual distributions commence 3 or 4 months after the annuity starting date.

IRS Response: The Service representative agrees with the proposed response that a plan may have a shorter period.

41. § 436 – Notice on Benefit Restrictions

Must the notice on benefit restrictions under Section 436 of the Code be provided to all participants and beneficiaries, regardless of whether the participant will be subject to the benefit restriction? For example, if a defined benefit plan only provides lump sums for accrued benefits equal to \$25,000 or less, must the notice be provided to those participants who are in pay status or who have an accrued benefit of more than \$25,000?

Proposed Response: The notice of benefit restrictions only must be provided to affected participants (*i.e.*, those who may be subject to the benefit restriction).

IRS Response: The Service representative indicated that he did not have an answer to this question. The Service representative indicated that jurisdiction for Section 101(j) was recently moved from the Department of Labor to the Treasury Department. The Service representative indicated that they intend to issue guidance on this in the future and that they will try to connect it to the subsequent guidance issued under Section 436 relating to benefit limitations.

42. § 451 – Cash Waiver of Future Retiree Health Benefits

An employer (a local government agency) provides retiree health benefits to eligible former employees. In an effort to reduce its retiree health care costs, the employer intends to offer current employees a one-time lump sum cash payment in lieu of retiree health. This arrangement would be offered outside of a Section 125 cafeteria plan. Specifically, a current employee may irrevocably waive his or her right to the future retiree health benefits for a one-time lump sum cash payment from the employer. The decision by an employee to take the cash option results in taxable income for that employee. Does the option also result in taxable income for the employees who keep their future retiree health benefits and do not opt to take the one-time payment?

Proposed Response: Yes. An option to take a one-time lump sum payment in lieu of future retiree health benefits amounts to offering a choice between taxable and nontaxable benefits. This choice results in the application of Section 451 and the constructive receipt doctrine. Under the cash receipts and disbursement method of accounting, amounts are included in gross income when actually or constructively received. Pursuant to Treasury Regulation Section 1.451-2(a), although not in the employee's actual possession, income is constructively received when income is otherwise made available so that the employee could have drawn upon it during the taxable year. In effect, it is as though the employee was given money today and used that money to purchase the future health insurance coverage. This is an assignment of income. As such, even if an employee keeps his or her future retiree benefits and does not opt to take the one-time lump sum payment, the employee will still be taxed as if he or she actually received the payment. Moreover, the constructive receipt doctrine cannot be avoided by offering the choice through a cafeteria plan because "the qualified benefits and the permitted taxable benefits offered through the cafeteria plan must not defer compensation. For example, a cafeteria plan may not provide for retirement health benefits for current employees beyond the current plan year..." Proposed Treasury Regulation Section 1.125-1(b)(5).

IRS Response: The Service representative indicated that Private Letter Ruling 200914018 addresses this situation. The Service representative cautioned that, as with all Private Letter Rulings, it applies only to the taxpayer who received the ruling. The Private Letter Ruling also should not be read beyond the facts that are in the Private Letter Ruling. The Private Letter Ruling provides that there is no constructive receipt in the facts presented solely because individuals were given the choice between future retiree health benefits and cash.

43. § 4980B – COBRA Premium Subsidy

Company X maintains a medical plan for its employees. Employee M is married to N. Employee M participates in the Company X medical plan. N works for Employer Q and participates in its medical plan. Assume that in July 2009, Company X involuntarily terminates Employee M's employment. At all times up to Employee M's termination of employment, Employee M is eligible

to be added as a dependent by N to the Employer Q medical plan. Is Employee M entitled to COBRA Premium Assistance?

Proposed Response: No, because Employee M is eligible for N's group health plan at the time he is involuntarily terminated by Company X. Under Section 4980B(f)(2)(B)(iv) of the Code, COBRA is required to continue up to the "date on which the qualified beneficiary first becomes, after the date of the election, covered under any other group health plan (as an employee or otherwise)." By contrast, American Recovery and Reinvestment Act Section 3001(a)(2)(A)(i), COBRA premium assistance "shall not apply with respect to any assistance eligible individual for months of coverage beginning on or after the earlier of the first date that such individual is eligible for coverage under any other group health plan." Because the premium assistance provision is not conditioned upon the employee's becoming eligible for the group health plan after electing COBRA, the employee must be given the right to elect COBRA but does not have to be provided with premium assistance for such coverage.

IRS Response: No, Employee M is not entitled to COBRA Premium Assistance. Notice 2009-27 has a number of questions and answers detailing when an individual is considered eligible for coverage under another group health plan.

44. § 4980B – COBRA Premium Subsidy

Employer L maintains a medical plan for its employees. Employer L also maintains a severance plan which has provided a subsidized COBRA benefit. Assume Employee C works for Employer L and his employment was involuntarily terminated in September 2009. As a result of Employee C's compensation during the year plus the amount of severance pay he is expected to receive during the year, Employee C reasonably believes that any premium subsidy received would become at least partially taxable under the income limitations of Section 3001(b) of the American Recovery and Reinvestment Act of 2009 ("Act"). Therefore, Employee C elects to waive premium assistance under Section 3001(b)(3) of the Act. If Employer L had amended its severance plan as a result of the Act to provide that if an employee elects to waive premium assistance, he will be provided a COBRA subsidy of an equal or greater percentage than the subsidy provided under the Act, is the subsidy with respect to Employee C excludable from Employee C's gross income under Section 106 of the Code as accident or health coverage provided by the employer?

Proposed Response: Yes. According to Section 3001(b)(1) of the Act, the recapture of the subsidy applies if "premium assistance is provided under this section" and according to Section 3001(b)(3)(A) of the Act, the "individual shall not be treated as an assistance eligible individual for purposes of this section ... if such individual makes a permanent election ... to waive the right to the premium assistance provided under this section." Since the COBRA subsidy provided after the employee waives such coverage is not provided under Section 3001 of the Act but is instead provided under the employer's severance plan, it is employer-provided accident or health coverage excludable from C's gross income under Section 106 of the Code.

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