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 11, 2012. 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. **§ 125 – Health Flexible Spending Accounts**

An employer offers two options for its group health plan – an HMO and a high deductible health plan (HDHP). The employer also offers two options for its health flexible spending account (health FSA) – a general health FSA, under which employee may make pre-tax contributions and be reimbursed for medical expenses (as defined under Section 213(d) of the Code), and a limited purpose health FSA, under which the employee may be reimbursed for dental expenses, vision expenses, and medical expenses that exceed the deductible under the HDHP. May the employer incorporate the terms of both health FSAs into one plan document?

**Proposed Response:** Yes. If the plan document specifies that there are two health FSA options (the general purpose and limited purpose options), the employer may set out the terms of each in one plan document. There is no need to adopt two separate plan documents.

**IRS Response:** The Service representative agrees with the proposed response, but indicated that the plan document must clearly state that the employee is in one health FSA or the other and the plan document must clearly state that the employee must choose the option for the entire year.

2. **§ 125 – Premiums for domestic partner coverage**

An employee elects medical coverage for himself and his domestic partner. The domestic partner is not the employee’s dependent. Due to administrative complexities in splitting premiums into pre-tax and after-taxes pieces, the employer collects premiums for the domestic partner’s coverage on a pre-tax basis and then imputes income to the employee. Is this practice permissible?

**Proposed Response:** Yes. Although an employee may not pay medical premiums on a pre-tax basis for a domestic partner who is not his dependent under Section 105(b) of the Code, Prop. Treas. Reg. Section 1.125-1(h) permits the employer to initially deduct the domestic partner’s share of the premium on a pre-tax basis and then impute income to the employee equal to the entire cost of coverage for the domestic partner (employer portion and employee portion) because the employee is, in fact, paying the domestic partner premium on an after-tax basis.

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

3. **§ 223 – Individual Not Initially Eligible**

An individual opens an HSA, believing that he is an “eligible individual.” The individual makes after-tax contributions over a period of a few years. The individual then learns that he was not an eligible individual on the day he first attempted to establish the HSA and made the first HSA contribution.

**Question A:** The individual learns that he was never, at any point during the years at issue, an eligible individual. Can the individual receive the HSA contributions without the funds being deemed a distribution under Code Section 223(f)?

**Proposed Response A:** Yes. The individual would not receive a distribution for purposes of Code Section 223(f) when he receives the amounts. Because the individual was never an eligible individual, no HSA exists. IRS Notice 2008-59, Q&A 23. The individual may need to restate his tax returns for prior years (e.g., if the individual claimed a deduction for the HSA contributions).

**IRS Response A:** The Service representative agrees with the proposed response.
4. **§ 401 – Correction for partial year missed deferral**

Section 2.02(1)(a)(ii)(F) of Appendix B of Rev. Proc 2008-50 provides an exception to correcting missed deferrals for partial year exclusions for a brief period. If a participant’s deferral election is not implemented for one pay period in January but the employee later terminates in August of that same year, can the employer still rely on this exception because at the time of missed deferral, the participant had the opportunity to make elective deferrals under the plan for a period of at least 9 months in that plan year? Or does the opportunity need to be determined as of the end of the plan year?

**Proposed Response:** Plan Sponsor should be able to determine the opportunity at the time of the missed deferral and a subsequent termination (whether voluntary or involuntary) in the same plan year should not have an impact.

**IRS Response:** The Service representative disagrees with the proposed response. Section 2.02(1)(a)(ii)(F) of Appendix B only applies to eligible employees who are improperly excluded from a Section 401(k) plan. These provisions do not apply to resolve failures that involve a failure to timely implement a participant’s election to defer compensation. This question is about a failure to implement a participant’s election, rather than not allowing a participant the opportunity to defer. Appendix A, Section .05 includes rules about the failure to implement a participant’s deferral election. If the facts in the question did involve an improperly excluded employee, the exception for a brief period of exclusion would only be applicable if the employee actually had at least nine months of the plan year to defer salary. If that timeframe is cut short due to a subsequent termination of employment, the rules of the safe harbor are not satisfied. Whether a full correction of the missed deferral would be required in every single situation that might come up under EPCRS where someone is improperly excluded would depend on the facts and circumstances.

5. **§ 401(a) and § 414(u) – USERRA and True-Up of Matching Contribution**

An employer sponsors a 401(k) plan that provides for a matching contribution of 100% on the first 4% of compensation. The 401(k) plan provides the matching contribution is to be contributed with each payroll and also provides that after the end of the plan year the employer will make a “true-up” matching contribution. The true-up matching contribution looks at an employee’s elective contributions, matching contributions, and compensation for the entire year. For example, if an employee does not make any elective contributions during the first three months of the plan year but contributes 10% the remainder of the plan year, although the employee has contributed more than 4% of compensation for the whole of the plan year the employee did not receive matching contributions for payrolls during the first three months. The true-up matching contribution after the end of the plan year makes up for the matching contributions missed during the first three months.

If an employee of the employer is on qualified military service for a portion of the plan year, does the employer need to impute income to the employee for that portion of the plan year when calculating the true-up matching contribution under the 401(k) plan?

**Proposed Response:** Yes. The regulations under USERRA indicate that compensation is to be imputed to an employee if necessary to determine the employee’s retirement contribution. See 20 C.F.R. § 1002.267.

**IRS Response:** The Service representative agrees with the proposed response, subject to a couple of caveats. The Service representative noted that the USERRA rules only apply under conditions that qualify the individual for USERRA. The Service representative is assuming that the employee
was reemployed under USERRA. The Service representative also noted that the question is referring to a true-up of matching contributions, which is independent of any post-reemployment elective deferrals and matching contributions that might apply to those make-up elective deferrals. The Service representative declined to comment on whether the facts in this question comply with the rules on post-reemployment elective deferrals. The Service representative also noted that a similar concept is addressed in the IRS Employee Plans News Spring 2004 edition and on the IRS website in a series of FAQs.

6. § 401(a)(4) – Determination of “Top 25” List

Treasury Regulation Section 1.401(a)(4)-5(b)(3) contains rules limiting distributions to “restricted employees” under a pension plan. Treas. Reg. Section 1.401(a)(4)-5(b)(3)(ii) defines “restricted employee” as:

any HCE or former HCE. However, an HCE or former HCE need not be treated as a restricted employee in the current year if the HCE or former HCE is not one of the 25 (or a larger number chosen by the employer) nonexcludable employees and former employees of the employer with the largest amount of compensation in the current or any prior year.

Question A: Assume an employer maintains a defined benefit plan. When compiling the “top 25” list for purposes of Treas. Reg. Section 1.401(a)(4)-5(b)(3), may an employer include a former employee in the top 25 list if the former employee never participated in the defined benefit plan?

Proposed Response A: Yes. When compiling the “top 25” list, there is no requirement that only plan participants must be included in the list. For purposes of the distribution limitations under Treas. Reg. Section 1.401(a)(4)-5(b)(3), a “former employee” is defined under Treas. Reg. Section 1.410(b)-9. Under Treas. Reg. Section 1.410(b)-9, a “former employee” is “an individual who was, but has ceased to be, an employee of the employer.” Under Treas. Reg. Section 1.410(b)-9, an “employee” is “an individual who performs services for the employer who is…a common law employee of the employer…In addition, an individual must be treated as an employee with respect to allocations…under a defined benefit plan that are based on ongoing service or compensation (including imputed service or compensation) credits.”

In sum, under Treas. Reg. Section 1.410(b)-9, a former employee includes any individual that use to be a common law employee of the employer, without regard to whether or not that individual participated or continues to participate in a defined benefit plan. Thus a former employee with the largest amount of compensation in the current or any prior year can be part of the “top 25” list even if he never participated in the employer’s defined benefit plan.

IRS Response A: The Service representative agrees with the conclusion, but for different reasons. The employee does not have to have benefitted under the plan in order to count them in the top 25. Treas. Reg. Section 1.401(a)(4)-5(b)(3)(ii) defines a “restricted employee” in relevant part as a “nonexcludable employee or former employee.” Under the definition of “Employee” in Treas. Reg. Section 1.401(a)(4)-12, an employee is defined as someone who benefits as an employee under the Plan. That same section, however, includes a broader definition of nonexcludable and it does not pick up the benefitting concept. Instead, it cross references Treas. Reg. Section 1.410(b)-9, which does not include a benefitting requirement. In short, the top 25 can include all employees, not just those who benefit under the plan.
Question B: Would the answer to Question A change if the former employee used to participate in the defined benefit plan but is no longer a participant because he received a total distribution of his interest from the defined benefit plan?

Proposed Response B: No. A former employee with the largest amount of compensation in the current or any prior year can be part of the “top 25” list even if he once participated in the employer’s defined benefit plan but no longer participates because he received a total distribution of his interest from the defined benefit plan.

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

Question C: Assume an employer’s defined benefit plan defines “restricted employee” using the exact definition found in Treas. Reg. Section 1.401(a)(4)-5(b)(3)(ii) as quoted above. When compiling the “top 25” list, may the employer consider compensation in only those prior years for which it has readily available compensation data (e.g., 7 prior years)?

Proposed Response C: Yes. The reference to “compensation in the current or any prior year” does not require the employer to compile the “top 25” list using compensation data for all prior years (e.g., those prior years pre-dating the regulation, pre-dating ERISA or those prior years for which the employer no longer has compensation data). The employer may consider only the prior years for which it reasonably retains compensation data. The employer furthermore is not required to amend its plan document to consider only the prior years for which it reasonably retains compensation data.

IRS Response C: The Service representative agrees with the proposed response, but with the caveat that it is not opining on what is a reasonable retention period for compensation data. The Service representative noted that in general, plan sponsors should maintain compensation data sufficient to administer the plan. The Service representative stated that in reality there might be circumstances in which data is not available and that since employee compensation tends to increase over time, presumably in most cases this would not be a key issue.

7. § 401(a)(4) – Interaction Between the General Test and Benefits, Rights and Features Test

Must a defined benefit plan test an early retirement subsidy feature as an optional form of benefit under the Benefits, Rights and Features Test if the plan passes the General Test to meet the nondiscrimination in amount of benefits requirements of Treas. Reg. Section 1.401(a)(4)-3 and takes the early retirement subsidy into account in running the General Test?

Proposed Response: No. A defined benefit plan is not required to test an early retirement subsidy feature as an optional form of benefit under the Benefits, Rights and Features Test if the plan passes the General Test to meet the nondiscrimination in amount of benefits requirements of Treas. Reg. Section 1.401(a)(4)-3 and takes the early retirement subsidy into account in running the General Test.

By way of example, assume that a large defined benefit plan covers two groups of participants: Group A and Group B. A different benefit formula applies to each group. Benefits become available before the plan’s Normal Retirement Date under the same early commencement and form of payment rules for both Groups A and B. However, the Group A structure provides subsidized early retirement benefits while the Group B structure does not.
The plan uses and passes the General Test to meet the nondiscrimination in amount of benefits requirements of Treas. Reg. Section 1.401(a)(4)-3. In applying that test, the value of the subsidized early retirement benefit is taken into account in determining accrual rates of Group A employees as required by Treas. Reg. Section 1.401(a)(4)-3(d)(1)(ii). Thus, it would seem that the rule in Treas. Reg. Section 1.401(a)(4)-4(e)(1)(ii) should apply, which says that differences in benefit formulas and accrual methods are to be ignored when applying the rules to determine whether there is more than one optional form of benefit. Since the early retirement subsidy for Group A is tested as an accrual under the General Test it would be ignored for purposes of the Benefits, Rights and Features Test and is not required to be separately tested under the Benefits, Rights and Features Test.

IRS Response: The Service representative disagrees with the proposed response. Treas. Reg. Section 1.401(a)(4)-4(e)(1) provides the general rule as follows:

The term “optional form of benefit” means a distribution alternative (including the normal form of benefit) that is available under the plan with respect to benefits described in Section 411(d)(6)(A) or a distribution alternative that is an early retirement benefit or retirement-type subsidy described in Section 411(d)(6)(B)(i), including a QSUPP. Except as provided in paragraph (e)(1)(ii) of this section, different optional forms of benefit exist if a distribution alternative is not payable on substantially the same terms as another distribution alternative. The relevant terms include all terms affecting the value of the optional form, such as the method of benefit calculation and the actuarial assumptions used to determine the amount distributed. Thus, for example, different optional forms of benefit may result from differences in terms relating to the payment schedule, timing, commencement, medium of distribution (e.g., in cash or in kind), election rights, differences in eligibility requirements, or the portion of the benefit to which the distribution alternative applies.

Thus, each distribution alternative that is available under the plan with respect to the subsidized or early retirement benefit and each distribution alternative that is available under the plan with respect to the unsubsidized early retirement benefit is a separate, optional form of benefit that separately must satisfy the requirements of Treas. Reg. Section 1.401(a)(4)-4. Moreover, if the plan provided different levels of subsidy from an early retirement benefit, each distribution alternative available at each level of subsidy would be a separate optional form of benefit. Treas. Reg. Section 1.401(a)(4)–4(e)(1)(ii) provides that benefit formulas, accrual methods or other factors including service computation methods and definitions of compensation underlying, or the manner in which employees vest in, the accrued benefit that is paid in the form of the distribution alternative are disregarded in determining whether there is more than one optional form of benefit. This regulation does not permit a retirement-type subsidy, such as an early retirement subsidy, to be ignored.

8. § 401(a)(31) – Cash Out Provision

A plan consists of a 401(k) and an ESOP portion and contains all of the required 401(k) and ESOP provisions. The plan also has a cash out feature under Section 401(a)(31) of the Code. Can the cash-out provision apply separately to the 401(k) portion and the ESOP portion of the plan?

Proposed Response: The cash-out provision applies to the entire plan (i.e., the total of a participant’s account under the plan is used for administering the cash-out provision under the plan).
IRS Response: The Service representative agrees with the proposed response.

9. **§ 401(k) – Failure to Timely Enroll Participant**

A non-safe harbor 401(k) plan discovers that it failed to timely enroll an eligible employee. The employee became eligible in February, and the error was not discovered until September. The plan year is the calendar year. EPCRS examples suggest using the ADP for the year of exclusion, but only address errors where the ADP is already known. Since the error is discovered is mid-way through the plan year, the ADP for the year is not yet known.

**Question A:** How should the employer correct this error?

(a) Contribute an estimated amount for the employee in September and do a “true-up” after the plan year ends, for any additional amount owed based on the actual ADP. If the estimated amount is greater than what the actual ADP would have required, what should be done with the excess amount?

(b) Wait to correct until the plan year is over and the ADP for the year of the exclusion is known.

**Proposed Response A:** The employer may correct using either method (a) or (b) above. If method (a) is used to correct the error, and the estimated amount contributed is greater than the amount that would have been required by the actual ADP, the excess amount (as adjusted for gains/losses) should be forfeited from the participant’s account and transferred to the plan’s unallocated account.

**IRS Response A:** The Service representative indicated that for purposes of the response, the Service is assuming that the failure to enroll the eligible employee is the result of the exclusion of a newly eligible employee from the non-safe harbor 401(k) plan for the period. It has nothing to do with the failure to timely implement an employee election. Assuming these are the facts, the Service representative agrees with the proposed response, which is that the employer may correct using either method (a) or (b). In addition, to the extent that there is an excess amount due to making an estimated contribution in September that was more than required, the Service representative’s position is that the excess amount would have to be treated as an employer contribution for the year contributed and handled in accordance with the general terms of the plan. It cannot be treated as a regular plan forfeiture or miscellaneous contribution and placed in an unnamed, unallocated plan account.

**Question B:** Does the appropriate method of correction change if the error is discovered in April?

**Proposed Response B:** No, the options for correction would not be affected.

**IRS Response B:** The Service representative stated that it is the Service’s position that it is always better to attempt to fix a problem earlier, rather than later. There are a couple reasons to fix a problem earlier. First, the longer a plan sponsor waits to correct the error, the more it will cost to fix since the amount will need to be adjusted for earnings or interest. Second, waiting to fix an error increases the possibility that the plan sponsor may not be eligible to make that correction voluntarily under EPCRS since there is always the possibility that the Service could audit the plan or there could be some other condition which would end up rendering the plan not eligible for EPCRS.
10. § 401(k) – Qualified Reservist Distributions

The Pension Protection Act of 2006 added qualified reservist distributions pursuant to Section 401(k)(2)(B) of the Code. If a plan permits in-service distributions for hardships or attaining age 59½, is it required to provide for qualified reservist distributions?

Proposed Response: No. Qualified reservist distributions are optional, not mandatory. Section 401(k)(2)(B) of the Code provides that amounts “which are attributable to employer contributions made pursuant to the employee’s election— (i) may (emphasis added) not be distributable to participants or other beneficiaries earlier than... (V) in the case of a qualified reservist distribution (as defined in section 72(t)(2)(G)(iii)), the date on which a period referred to in subclause (III) of such section begins…”

Section 401(k)(2)(B) of the Code prescribes the earliest dates on which a participant or beneficiary may receive a distribution. The use of “may” clearly provides that qualified reservist distributions are discretionary, not mandatory.

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

11. § 401(k)(12) – Spin-off of Safe Harbor Plan

Question A: Can a plan be spun out from a safe-harbor plan mid-year due to a corporate event (i.e., the employer is restructured and part of the employer becomes an unrelated employer) without violating the initial plan’s safe-harbor status?

Proposed Response A: Yes, since the plan continues in the same fashion for the participants subsequent to the corporate event. The spin-off does not impact the safe harbor notice that was provided to the participants.

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

Question B: Can the unrelated employer maintain the spun-off plan as a safe-harbor plan?

Proposed Response B: Since the employer that spun-off is an unrelated employer, the plan that results from the spin-off is not a “successor plan.” As such, the unrelated employer can establish a safe-harbor plan mid-year provided it is established at least 3 months prior to the end of the plan year.

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

12. § 402(c) – Tax Treatment of Rollovers

Notice 2009-68 has caused some confusion by suggesting that there may be a distinction in the tax treatment of partial rollovers based on whether the rollover is a direct or an indirect partial rollover. Is there any distinction from a tax treatment standpoint whether the rollover is accomplished by a direct rollover from an eligible retirement plan or by an indirect rollover during the 60 days following receipt of a distribution from an eligible retirement plan?

Proposed Response: This question was originally posed to the Service in 2010. The Service indicated that it was looking at this issue. The Service’s answer to this question in 2010 was:
Notice 2009-68, which is commonly referred to as the Section 402(f) notice, provides for safe harbor explanations that may be provided to participants who receive eligible rollover distributions. The Notice addresses a situation in which amounts that include after-tax contributions are rolled to an IRA. The Notice provides that if a portion of a participant’s account is directly rolled over to an IRA and a portion of the account is distributed directly to the participant, those are two separate distributions. For each of those distributions, an allocable portion of the after-tax contributions must be included, which means that each distribution is partially taxable. Questions have been raised about the difference between this situation and the situation in which a participant receives a distribution of the account and then rolls over a portion of the distribution. In that situation, Section 402(c)(2) applies and the after-tax portion of the rollover is treated as being rolled over first. The focus is not on whether it is a direct rollover or a distribution to the participant. Rather, the question is how many distributions are there in this situation? If there are two different recipients for a plan distribution, under the Section 402(f) notice, the IRS’ position is that there are two distributions. Assume for example that a participant has an account balance of $40,000, of which $10,000 consists of after-tax contributions. Assume that the participant requests a direct rollover of $30,000 to an IRA. If this rollover was consistent with Section 402(c)(2), then the $30,000 amount would be treated as a rollover of pre-tax contributions. The question is why that is not how this rollover is treated. If the $30,000 is treated as a separate distribution, there is not a partial rollover of that amount. The entire $30,000 distribution is being rolled over to an IRA and, therefore, an allocable amount of that rollover is treated as after-tax dollars. The Service representative indicated that that is the position in the Section 402(f) Notice and that it has received many questions and comments asking the Service to reconsider its view. The Service representative indicated that the Service is looking into this issue.

Has the Service looked into this issue? Practitioners believe that the answer should be the response proposed in 2010, which was:

There is no distinction in the tax treatment of direct partial rollovers and indirect partial rollovers. In accomplishing a single rollover distribution, the language of Section 402(c)(2) of the Code applies to both distributions from direct partial rollovers and indirect partial rollovers such that “the amount transferred shall be treated as consisting first of the portion of such distribution that is includible in gross income.” This means that the participant can rollover the taxable portion of the distribution and retain the portion of the distribution that is non-taxable due to representing after-tax contributions, whether the rollover is accomplished by a direct rollover or an indirect rollover. Because of the application of the provisions of Section 402(c)(2) of the Code, pre-tax amounts are deemed rolled over before any after-tax contributions.

IRS Response: The Service representative indicated that the Service is developing guidance on this issue and it anticipates issuing the guidance soon.

13. § 402(c) – Direct Rollover

If the IRS has not changed its position on direct rollovers in connection with defined contributions plans, is the response any different in the following situations? An employer sponsors a defined
benefit pension plan with (frozen) after-tax employee contributions. Individuals are permitted to take a lump sum distribution of their after-tax contributions (and interest credits on such amounts) at any time following termination of employment, and participants who attain retirement age (early, normal or late) may also be eligible to elect to receive the employer contributions in the form of a lump sum. However, the plan states that the employer provided accrued benefit cannot begin to be paid to the participant until retirement age. If a participant wishes to take a distribution of his or her after-tax contributions after termination of employment and before retirement age, is it possible for the participant to complete a direct rollover of only the after-tax contributions to an IRA, or a direct rollover of only the taxable interest credits to an IRA? If not, then can the after-tax contributions and the taxable interest credits be distributed in a lump sum (subject to the 20% withholding requirement on taxable amounts), and the taxable interest credits rolled over to an IRA in a 60-day rollover? If the individual is currently employed with a new employer, and the new employer’s qualified retirement plan permits rollover contributions of only taxable distributions from other Code § 401(a) plans, can such an individual complete a direct rollover of only the taxable interest credits to the new employer’s qualified plan, and then either complete a direct rollover to an IRA of the remaining after-tax contributions, or take a non-taxable distribution of such remaining amounts?

Proposed Response: The participant can rollover the distribution of after-tax contributions in a direct rollover to an IRA (or to another Code § 401(a) plan that will separately account for such amounts) without any portion of the rolled over amount being considered pre-tax earnings. The participant who receives a distribution of the after-tax contributions will not be considered to have received any earnings with respect to that distribution. Such a distribution cannot be rolled over in a 60-day rollover (because after-tax contributions can be rolled only in a direct rollover), but none of the distribution is considered taxable. In any event, the participant can complete a direct rollover of the taxable interest credits to a new employer’s Code § 401(a) plan which will accept the rollover, and may then complete a direct rollover to an IRA of the remaining after-tax contributions, or take a non-taxable distribution from the plan of such amounts.

Note that an employee could make a direct rollover of the entire after-tax contributions and interest credits to an IRA and then transfer the earnings in a rollover to a new employer’s plan that will accept the rollover. Under Section 408(d)(3)(H)(ii) none of the rollover amount would be considered after-tax contributions. The employee could then take a distribution of the remainder of the IRA (consisting of only after-tax contributions) and wind up with the after-tax contributions outside an IRA or qualified plan and the interest credits in a rollover account. It does not make sense to require the employee to achieve in this back door fashion what should be achievable through a straight forward distribution/rollover process.

IRS Response: The Service representative indicated that the Service is developing guidance on this issue and it anticipates issuing the guidance soon.

14. § 402(c)(11) – Amendment for Rollovers by Non-Spouse Beneficiaries

Section 108(f) of the Worker, Retiree, and Employer Recovery Act of 2008 (“WRERA”) amended Section 402(c)(11) of the Code in effect to require qualified retirement plans to permit direct rollovers to individual retirement plans on behalf of non-spouse beneficiaries. Is such an amendment required for a plan which, under its terms, cannot make eligible rollover distributions to non-spouse beneficiaries?

Consider, for example, a defined benefit plan that provides for the distribution of benefits in the form of single-life annuities and joint-and-survivor annuities. A participant (with the consent of his
or her spouse, if married) may elect a joint-and-survivor annuity with a non-spouse survivor annuitant. In such a case, any survivor benefits to a non-spouse survivor annuitant would be for the latter’s life, and would therefore not be eligible rollover distributions. The only other form of benefit under the plan is a cash-out distribution for participants who terminate employment and whose benefits have a present value not exceeding $1,000. If a married participant with a vested benefit dies before his benefits begin, a pre-retirement survivor annuity is payable to his surviving spouse. If a non-married participant who is vested dies before his benefits begin, no benefits are payable.

Proposed Response: If a plan, under its terms, cannot make eligible rollover distributions to non-spouse beneficiaries, it is not necessary to amend the plan to comply with Section 108(f) of WRERA to permit rollovers by non-spouse beneficiaries.

IRS Response: The Service representative indicated that it is in the plan’s best interest to include the language for ease of processing, especially in the determination letter process. Even if the language is not required, if the plan has an inexperienced reviewer, the reviewer will see that the language is not included in the plan. The reviewer will follow up with the plan sponsor on the language and the plan sponsor will have to challenge it with the reviewer. The reviewer will have to elevate this to his/her supervisor and finally come to a resolution. Accordingly, it is often in the plan’s best interest to simply include the language.

15. § 402(f) – Direct Rollovers


SPECIAL RULES AND OPTIONS

If your payment includes after-tax contributions

After-tax contributions included in a payment are not taxed. If a payment is only part of your benefit, an allocable portion of your after-tax contributions is generally included in the payment. If you have pre-1987 after-tax contributions maintained in a separate account, a special rule may apply to determine whether the after-tax contributions are included in a payment.

You may roll over to an IRA a payment that includes after-tax contributions through either a direct rollover or a 60-day rollover. You must keep track of the aggregate amount of the after-tax contributions in all of your IRAs (in order to determine your taxable income for later payments from the IRAs). If you do a direct rollover of only a portion of the amount paid from the Plan and a portion is paid to you, each of the payments will include an allocable portion of the after-tax contributions. If you do a 60-day rollover to an IRA of only a portion of the payment made to you, the after-tax contributions are treated as rolled over last. For example, assume you are receiving a complete distribution of your benefit which totals $12,000, of which $2,000 is after-tax contributions. In this case, if you roll over $10,000 to an IRA in a 60-day rollover, no amount is taxable because the $2,000 amount not rolled over is treated as being after-tax contributions.
You may roll over to an employer plan all of a payment that includes after-tax contributions, but only through a direct rollover (and only if the receiving plan separately accounts for after-tax contributions and is not a governmental Section 457(b) plan). You can do a 60-day rollover to an employer plan of part of a payment that includes after-tax contributions, but only up to the amount of the payment that would be taxable if not rolled over.

Read literally, the safe harbor explanation requires a different result if a participant chooses a direct rollover to an IRA of a distribution which includes after-tax contributions, instead of either a 60-day rollover to an IRA or a direct or indirect rollover to an employer plan. In the example given, the participant is receiving a complete distribution of her retirement plan benefit which totals $12,000, of which $2,000 is after-tax contributions. The participant would like to take a distribution of the after-tax amounts in cash, but would like to preserve the tax-deferred nature of the pre-tax amounts by rolling those amounts to an IRA or an employer plan. Here are the results, according to the safe harbor explanation:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Roll over $10,000 to an IRA in a direct rollover and receive a distribution of $2,000.</td>
<td>IRA deposits are deemed to be $8,333 pre-tax and $1,667 after-tax. Distribution is deemed to be $333 non-taxable and $1,667 taxable.</td>
</tr>
<tr>
<td>Receive distribution of $12,000 and roll over $10,000 to an IRA in a 60-day rollover.</td>
<td>$10,000 pre-tax IRA deposit. No amount is taxable.</td>
</tr>
<tr>
<td>Roll over $10,000 to an employer plan in a direct rollover and receive a distribution of $2,000.</td>
<td>Plan rollover deemed to be $8,333 pre-tax and $1,667 after-tax. Distribution is deemed to be $333 non-taxable and $1,667 taxable.</td>
</tr>
<tr>
<td>If the target plan does not accept rollovers of after-tax amounts, this participant will not be able to effect a direct rollover to the plan for any portion of their distribution.</td>
<td></td>
</tr>
<tr>
<td>Receive distribution of $12,000 and roll over $10,000 to an employer plan in a 60-day rollover.</td>
<td>$10,000 pre-tax rollover. No amount is taxable.</td>
</tr>
</tbody>
</table>

Are these results consistent with existing law and Congressional intent?

Proposed Response: This question was posed to the IRS in 2010. The following was the proposed response provided in 2010:

Based upon the language of the safe harbor explanation, a direct rollover would produce a different result than an indirect rollover with a less favorable tax treatment for a direct rollover. The safe harbor Section 402(f) notice is inconsistent with Section 402(c)(2) of the Code, which provides that if a participant is rolling over a portion of a distribution which includes employee after-tax contributions, “the amount transferred shall be treated as first consisting of the portion of the distribution that is includible in gross income.” In addition,
the language of the safe harbor Section 402(f) notice seems contrary to Congressional intent. The Job Creation and Worker Assistance Act (JCWAA) contained clarifying amendments to the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that amended Section 402(c)(2) to permit employee after-tax contributions to be rolled over. The JCWAA Committee Report specifically provides that when a distribution includes both pre-tax and after-tax amounts, the portion of the distribution representing the pre-tax portion will be treated as rolled over first:

*Joint Committee on Taxation Report [JCX-12-02] Rollovers of retirement plan and IRA distributions.* Under prior law and under the Act, a qualified retirement plan must provide for the rollover of certain distributions directly to a qualified defined contribution plan, a qualified annuity plan, a tax-sheltered annuity plan, a governmental eligible deferred compensation plan, or a traditional IRA, if the participant elects a direct rollover. The provision clarifies that a qualified retirement plan must provide for the direct rollover of after-tax contributions only to a qualified defined contribution plan or a traditional IRA. *The provision also clarifies that, if a distribution includes both pretax and after-tax amounts, the portion of the distribution that is rolled over is treated as consisting first of pretax amounts.*” (emphasis added)

This was an unintentional oversight by the Service when drafting the safe harbor explanation. The use of an explanation intended to satisfy Section 402(f) of the Code, but which differs from Notice 2009-68 in its description of the tax treatment of a direct rollover of a portion of a distribution including taxable and non-taxable amounts, will be deemed by the Service to constitute a safe harbor explanation. In addition, the Service will provide public clarification of its position on the tax treatment of a direct rollover of a portion of a distribution including taxable and non-taxable amounts, which will be consistent with Section 402(c)(2) of the Code.

In 2010, the Service disagreed with the proposed response but indicated it planned to look at this issue further. Has the Service revised its position on the proposed response?

**IRS Response:** The Service representative indicated that the Service is developing guidance on this issue and it anticipates issuing the guidance soon.

16. **§ 402(1) – Direct Rollovers**

In 2010, the Service responded to this question and disagreed with the proposed responses provided below. The Service indicated that it would look at these issues further. Has the Service revised its position on the proposed responses below?

**Question A:** A participant in a Section 401(a) plan has an after-tax account which includes after-tax contributions and pre-tax earnings and wants to roll over only the pre-tax earnings to another employer plan (such as a qualified plan or a Section 403(b) plan which accepts after-tax contributions and has separate accounts for after-tax contributions) through a direct rollover. Can the participant do this?

**Proposed Response A:** Section 402(c)(2) of the Code applies and thus, the participant could directly rollover only the pre-tax earnings to a qualified plan or a Section 403(b) plan.
**Question B**: If a participant wants to *directly rollover* only a portion of the distribution to another employer plan (such as a qualified plan or a Section 403(b) plan) which includes both after-tax contributions and pre-tax earnings, what is the ordering rule? For example, a participant has $10 in her eligible employer plan account and $8 is after-tax and $2 is pre-tax. The participant wants to roll over only $3 to another employer plan and receive $7 as cash distribution. What is the tax consequence to this participant?

**Proposed Response B**: Section 402(c)(2) of the Code applies and thus, pre-tax earnings should be treated as rolled over first. In the example, if a participant directly rolls over $3 and receives $7 in cash, the participant should not be taxed on any amount because all the pre-taxed money was rolled over to another qualified plan.

**Analysis**: The Safe Harbor Section 402(f) Notice issued by the Service (Notice 2009-68) states the following:

> You may roll over to an employer plan all of a payment that includes after-tax contributions, but only through a direct rollover (and only if the receiving plan separately accounts for after-tax contributions and is not a governmental section 457(b) plan). You can do a 60-day rollover to an employer plan of part of a payment that includes after-tax contributions, but only up to the amount of the payment that would be taxable if not rolled over.

This Notice seems to provide that the participant cannot roll over only the pre-tax earnings through a direct rollover and that the participant can do this only through a 60-day rollover. This means that the participant must receive the cash distribution and the plan must withhold 20% of the payment for federal income tax purposes, and the participant has to make the deposit within 60 days. Such practice would impose a burden on the participant because he or she must come up with the 20% withheld money within 60 days in order to make a tax free rollover. The Notice also differentiates between a direct rollover and a 60-day rollover and requires that if a participant wants to directly rollover only a portion of distribution that includes both after-tax and pre-tax money, he or she must prorate the portion between the allocable portion of after-tax and pre-tax. There is no basis for making such distinction.

This Notice seems to be in conflict with the ordering rule of Section 402(c)(2) of the Code and Publication 571. Section 402(c)(2) of the Code states “the amount transferred shall be treated as consisting first of the portion of such distribution that is includible in gross income.” Further, Section 402(c)(2)(A) specifically refers to a direct rollover of after-tax contributions to a qualified plan or a Section 403(b) plan. Therefore, a direct rollover of pre-tax amounts in the after-tax account should be allowed without having to prorate between after-tax contributions and pre-tax earnings.

Publication 571 (revised Dec. 2009) further supports this conclusion. Under the heading “Rollovers to and from 403(b) Plans” of the Publication 571, it states:

> If a distribution includes both pre-tax contributions and after-tax contributions, the portion of the distribution that is rolled over is treated as consisting first of pre-tax amounts (contributions and earnings that would be includible in income if no rollover occurred). This means if you roll over an amount that is at least as much as the pre-tax portion of the distribution, you do not have to include any of the distribution in income.
Under the general rules of Section 72, distributions are prorated. It should be noted, however, that EGTRRA amended Section 402(c)(2) to provide that after-tax contributions may be rolled over from an employer plan. Therefore, Section 402(c)(2) should govern when the matter pertains to the rollovers of after-tax account and since Section 402(c)(2) does not distinguish a direct rollover from a 60-day rollover, it should not bring different tax results.

**IRS Response:** The Service representative indicated that the Service is developing guidance on this issue and it anticipates issuing the guidance soon.

17. **§ 403(b) – Subsequent Exclusion of Employee**

Treasury Regulation Section 1.403(b)-5(b)(4)(D)(iii) provides that for purposes of the requirements of Treasury Regulation Section 1.403(b)-5(b)(4)(ii)(E), an employee normally works fewer than 20 hours/week if and only if – (1) the employer reasonably expects the employee to work fewer than 1,000 hours during the 12-month period beginning on the employee’s first day of employment, and (2) for each plan year ending after the close of the employee’s first 12-month period of employment, the employee worked fewer than 1,000 hours during the preceding 12-month period. Does this regulation mean that once an employee works 1,000 hours during a plan year, that employee will thereafter never be excludable for purposes of the universal availability rule, even if the employee moves from full-time employment to part-time employment?

**Proposed Response:** Yes. There is no exception in the regulations for employees who work 1,000 hours in one year and fewer than 1,000 in the next. Once an employee works 1,000 hours in a year and is thus covered for purposes of the universal availability rule, that employee must continue to be provided with the opportunity to make salary reduction contributions, even if he/she moves to a job classification that requires fewer than 1,000 hours/year. This rule applies regardless of whether the plan in question is covered by ERISA or exempt from ERISA (e.g., a church plan).

**IRS Response:** The Service representative indicated that they agree with the first sentence of the proposed response. There is no exception in the regulations for employees who work 1,000 hours in one year and fewer than 1,000 in the next. The Service representative indicated it was not commenting on anything else in the proposed response.

18. **§ 403(b)(12) – Calculating Hours of Work**

Treas. Reg. Section 1.403(b)-5(b)(4)(ii)(E) provides that a 403(b) plan will not fail to satisfy the universal availability requirement merely because it excludes employees who “normally work fewer than 20 hours per week.” Treasury Regulation Section 1.403(b)-5(b)(4)(iii)(B) provides a definition of an employee who normally works fewer than 20 hours per week. In that definition, the relevant 1,000 hours of service is defined with reference to Code Section 410(a)(3)(C) and is not modified in the same manner as in Treasury Regulation Section 1.403(b)-4(e)(6). Treasury Regulation Section 1.403(b)-4(e)(6) provides for a “different measure of work if appropriate under the facts and circumstances. For example, a plan may provide for a university professor’s work to be measure by the number of courses taught during an annual work period . . . .” Can that same measure be used when applying the “normally works fewer than 20 hours per week” rule in cases where an employer employs people such as adjunct professors for whom hours are not tracked. For example, could an educational institution provide that teaching 12 hours is considered full-time so that teaching less than 6 hours is the equivalent of “normally works fewer than 20 hours a week”?
Proposed Response: Yes, it is reasonable to assume such an equivalency could be used to determine whether the employee had worked 1,000 hours or more in a prior plan year for purposes of the “normally works fewer than 20 hours per week” rule.

IRS Response: The Service representative disagrees with the proposed response. Treas. Reg. § 1.403(b)-4(e)(6) explicitly states that the 1,000 hour rule is only for that paragraph and that a plan cannot import the definitions from another section.

19. § 409A – Change in Form of Payment

An employer (a service recipient) has a non-grandfathered plan subject to Section 409A that provides payments are to be made in an annuity form on a monthly basis for an employee’s (a service recipient’s) life. Although the value of an employee’s annuity is greater than the limit under Section 402(g)(1)(B) of the Code, the value of the monthly payments is small. The employer desires to amend the plan to provide the employee will receive an annual payment instead of a monthly payment. Assuming the value of the annual payment is actuarially equivalent to the value of the monthly payments in a year, may the employer amend the plan to change the number of payments made during the year from monthly payments to an annual payment?

Proposed Response: Yes. If the value of the annual annuity payment is actuarially equivalent to the value of the monthly annuity payments, the employer may amend the plan. See 26 C.F.R. § 1.409A-2(b) (indicating that changing annuity form prior to commencement of payment to an actuarially equivalent form is permitted under Section 409A of the Code).

IRS Response: The Service representative agrees with the proposed response. It is permissible to change from one form of life annuity to another form of life annuity payment as long as (1) the actuarial value of each life annuity is equivalent, (2) each life annuity has the same scheduled commencement date and (3) the change is made before the first scheduled payment date in accordance with the regulations issued under Section 409A.

20. § 409A – Determination of Specified Employees

Assume that an employee is employed by a non-public company, which was acquired by a public company in October 2010 in a stock transaction. Also assume that the default rules under Section 409A apply for purposes of determining who is a specified employee. In determining specified employees following a stock purchase, should compensation earned both before the stock purchase and compensation earned following the stock purchase be taken into account?

Proposed Response: Yes. Since the employee remained employed by the same corporation, all compensation earned from the relevant corporation is taken into account, regardless of whether the compensation was earned prior to the date on which the corporation was acquired by a public company.

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

21. § 409A – Revising Severance for an Expiring Agreement

An employment agreement for a public company specified employee contains an overly broad Good Reason definition and provides severance over 18 months, paid monthly. The agreement expires by its terms without payment on December 31, 2012. Alternatively, the agreement automatically renews for a year at a time but expires if either party gives notice of expiration 90
Proposed Response: Under these facts,

(a) if the contract has no evergreen provision and expires at December 31, 2012, the parties can provide for a new contract under terms that permit lump sum payment, whether agreed to in advance of, at, or after the expiration, and

(b) if the contract has an evergreen provision but the parties comply with (or agree to shorten) the notice periods for nonrenewal, the same answer applies. However, if the agreement rolls over to January 1, 2013 without prior agreement that it would expire on December 31, 2012, the parties will then need to wait until the next nonrenewal period before changing the payment timing. However, the parties could agree at any time that an amount up to the current severance levels would be paid under the current payment arrangement but any future amounts would be paid under a different schedule. The reasoning in all situations is that the changes relate to prospective deferred compensation, not to amounts previously deferred.

IRS Response: The Service representative agrees with the proposed response provided that the new payment provision only applies to the contract commencing on or after January 1, 2013 and the severance paid does not become payable if the agreement is not extended or renewed. Alternatively, if either party gives notice within the 90-day period in advance of renewal, then this is fine as long as the parties give notice of non-renewal and the new agreement is set up within that 90-day period and prior to the beginning of the new period covered by the severance agreement, then that would be fine under Section 409A as well.

22. § 410(b) – Coverage Requirements during Transition Period

Employer S, a tax-exempt entity, maintains a 401(k) Plan in which its employees participate. Employer S is acquired by Employer P, also a tax-exempt entity, in a transaction pursuant to which Employer P becomes the sole member of Employer S. At the time of the acquisition, Employer P sponsors a 403(b) plan in which Employer P’s employees participate, and a for-profit, taxable entity in Employer P’s controlled group sponsors a 401(k) Plan in which that entity’s employees participate. Employees of Employer P who are eligible to make salary reduction contributions under Employer P’s 403(b) Plan are treated as excludable for purposes of coverage and discrimination testing with respect to Employer P’s 401(k) Plan under Treasury Regulations Section 1.410(b)-6(g)(3). After the acquisition of Employer S, does the transition rule available under Treasury Regulation Section 1.410(b)-2(f) apply to the 401(k) Plan of Employer S such that Employer P may continue to rely on the testing exception under Treasury Regulation Section 1.410(b)-6(g)(3) for the duration of the available transition period?

Proposed Response: Yes, so long as all of the other requirements of Treasury Regulation Section 1.410(b)-2(f) are met with respect to the 401(k) Plan that is sponsored by tax-exempt Employer S and all of the other requirements of Treasury Regulation Section 1.410(b)-6(g)(3) are met with respect to the 401(k) Plan that is sponsored by the for-profit entity in Employer P’s controlled group.

Analysis: Treasury Regulation Section 1.410(b)-2(f) allows an acquired plan that satisfies Section 410(b) immediately prior to the acquisition to be treated as continuing to satisfy Section 410(b) of the Code for a limited period of time after the acquisition, if there is no significant change in the
plan or in the coverage of the plan other than the acquisition. For all testing purposes under Code Section 410(b), therefore, the acquired 401(k) plan is treated as satisfying the Code’s coverage requirements separate and apart from any other plans maintained by the acquiring entity.

Further, Treasury Regulation Section 1.410(b)-6(g)(3) excludes from the coverage test employees of a tax-exempt organization (as described in Section 403(b)(1)(A)(i)) who are eligible to make salary reduction contributions under Section 403(b), if (1) no employee of a tax-exempt organization is eligible to participate in such section 401(k) plan, and (2) at least 95% of the employees who are neither employees of a tax-exempt organization nor employees of a governmental entity who are precluded from being eligible employees under a section 401(k) plan by reason of section 401(k)(4)(B)(ii) are eligible to participate in such 401(k) plan.

The 401(k) Plan of Employer S will be treated as satisfying the coverage requirements for the transition period assuming there is no significant change in the plan or in the coverage of the plan other than the acquisition. The 401(k) Plan sponsored by the for-profit member of the acquiring entity’s controlled group will continue to be eligible to be tested separate and apart from the other members of the controlled group, including the 401(k) Plan of Employer S, for the duration of the transition period, as long as all requirements of the regulations continue to be met.

Specifically, the requirement that no employee of a tax-exempt organization be eligible to participate in “such 401(k) plan” will not be violated by the participation of the employees of Employer S in its separate 401(k) plan.

IRS Response: The Service representative indicated that they agree with the proposed response. The Service representative stated the fact pattern is fairly detailed and that they are concerned that in agreeing with the proposed response they want to make sure that it is not overly narrow in interpreting the transition rule. The transition rule is available for those plans.

23. § 411 – Voluntary Transfer Rules

The elective transfer rules under Treasury Regulation Section 1.411(d)-4, Q&A 3(b) are very specific and provide for elective transfers in two situations, change of employment status or due to an asset or stock acquisition, merger or other similar transaction involving a change in the employer of the employees of a trade or business, provided certain requirements are satisfied. However, Code Section 411(d)(6)(D) seems to provide an alternative set of rules.

Please clarify the interplay between the voluntary transfer rules set forth above. In particular, can a plan sponsor choose to comply with either the provisions of Code Section 411(d)(6)(D) or Treas. Reg. Section 1.411(d)-4, Q&A 3(b)?

Proposed Response: Code Section 411(d)(6)(D) provides an alternative set of voluntary plan transfer rules. A plan sponsor can choose to comply with either the provisions of Code Section 411(d)(6)(D) or Treas. Reg. Section 1.411(d)-4, Q&A 3(b) until further guidance is issued.

IRS Response: The Service representative agrees with the proposed response. The rules apply in slightly different situations. For example, Section 411(d)(6)(D) of the Code requires that the transferee plan offer a lump sum distribution option. That requirement is not in the proposed regulations. The proposed regulations require, for example, that the transfer is made in connection with a business transaction involving a change of employees of the employer or a change in the participant’s status so that they are no longer receiving allocations. That requirement is not in the statute. They are alternative approaches and they can be used in appropriate situations.
24. § 411(d) – Exception from Consent Rules

Treasury Regulation Section 1.411(d)-4 Q&A 2(b)(2)(vi) describes an exception from the consent rules for amounts over the cash-out limit ($5,000) for terminating non-pension plans that do not offer an annuity option where the employer does not maintain any other “defined contribution plan” other than an ESOP. Does “defined contribution plan” have the same meaning for this purpose as “alternative defined contribution plan” in Section 1.401(k)-1(d)(4)?

Proposed Response: Yes, the meaning is the same because plan-to-plan transfers are not permitted between the plans identified in Treasury Regulation Section 1.401(k)-1(d)(4). Treasury Regulation Section 1.411(d)-4 Q&A 2(b)(2)(iv) is designed to prevent an employer from terminating a plan while another plan is available to which plan-to-plan transfers can be made.

IRS Response: The Service representative disagrees with the proposed response. For purposes of the participant consent rule, not having any other defined contribution plan means not having any other defined contribution plan. An employer cannot latch onto the 401(k) rule.

25. § 417 – Use of Outdated Mortality Assumptions

A tax-qualified plan was timely adopted to specify the applicable mortality table for all purposes for which such a table is required under the Code. However, for some years, for other purposes, the plan was using a mortality assumption that would be regarded by most actuaries as outdated. A favorable determination letter issued to the plan did not question the mortality assumption. As a result, plan participants received a larger benefit than they would have received had a more current mortality table been used. The plan will be amended prospectively to reflect a more current mortality assumption.

Proposed Response: The use of an outdated mortality assumption for determining actuarial equivalence is not an operation defect, even if it resulted in participants receiving larger benefits than the plan sponsor intended, i.e., the intended benefit was the true actuarial equivalent. An alternative analysis would be a classic “Catch-22,” because applying a more current mortality table would have had the effect of not administering a plan in accordance with its terms.

Even though the benefit resulting from the application of an outdated mortality assumption was greater than the plan sponsor intended, it is nonetheless an accrued benefit that must be protected under the plan’s amendment. From a contractual perspective, this is a unilateral mistake that does not affect a participant’s entitlement to benefits.

IRS Response: The Service representative generally agrees with the proposed response, but noted that in the second paragraph, this mortality assumption created an optional form of benefit that must be protected under Section 411(d)(6) rather than an accrued benefit. The Service representative also declined to comment on the last sentence of the proposed response.

26. § 436 – Social Security Leveling Option

A final average pay defined benefit pension plan has an optional form of benefit providing a level income with Social Security and the pension plan. The plan describes the level income option as:

Level Income Option. If payment of a Participant’s benefit commences prior to the earliest age as of which such Participant will become eligible for an Old-Age Insurance Benefit under the Social Security Act and such Participant’s benefits
will be paid in the form of an annuity, then at the request of the Participant the amount of the payments of his benefits may be adjusted so that an increased amount will be paid prior to such age and a reduced amount thereafter; the purpose of this adjustment is to enable the Participant to receive from the Plan and under the Social Security Act an aggregate income in approximately a level amount for life. Such adjusted payments shall be the Actuarial Equivalent of the benefit otherwise payable to such Participant.

Assume that plan sponsor has filed a bankruptcy petition under Chapter 11 of the Bankruptcy Code. Is the level income option a prohibited payment under Section 436(d)(2) and Section 436(d)(5) of the Code?

**Proposed Response:** No. Code Section 436(d)(2) provides that during any period that a plan sponsor is a debtor under Chapter 11 of the Bankruptcy Code, it may not make a “prohibited payment.” Code Section 436(d)(5)(A) defines a “prohibited payment” as “any payment, in excess of the monthly amount paid under a single life annuity (plus any social security supplements described in the last sentence of section 411(a)(9). . .” The last sentence of Code Section 411(a)(9) and Treas. Reg. Section 1.411(a)-7(c)(4)(ii) define a Social Security Supplement as “a benefit for plan participants which –(A) commences before the age and terminates before the age when participants are entitled to old age insurance benefits, unreduced on account of age, under title II of the Social Security Act, as amended. . .” The level income option is a Social Security Supplement and therefore is not a “prohibited payment” under Code Sections 436(d)(2) and (5). See also Meehan v. Atlantic Mutual Insurance Company, 2008 U.S. Dist. Lexis 6920 (EDNY 2008) (a benefit “designed to provide a level income for employees electing to take early retirement who would have no income other than their pension from the time of retirement to the commencement of their Social Security” is found to be a Social Security supplement.)

**IRS Response:** The Service representative disagrees with the proposed response. The Service representative indicated that the proposed response is inconsistent with Treas. Reg. § 1.436-1(d)(3)(iii)(D)(2) and Treas. Reg. § 1.436-1(d)(3)(v), Example 3.