AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

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COMMITTEE ON EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS

INTERNAL REVENUE SERVICE

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The following questions and answers are based on an oral presentation made by IRS and Treasury officials at the Tax Section's Employee Benefits Committee meeting on May 9, 2014. 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. § 72 – Correction of Defaulted Loans

Section 72(p) and Treasury Regulations Section § 1.72(p)-1, Q&A 10 and 14, indicate that a deemed distribution generally occurs, and a Form 1099-R must be issued, whenever a borrower fails to make a loan installment payment by its due date (including any additional cure period provided by the plan).

Under Rev. Proc. 2013-12, Section 6.07, if the participant fails to make repayment, an operational failure will occur if the employer does not, at that time, default the loan, and issue the Form 1099-R. Section 6.07(2) provides that this operational failure may be corrected and the plan sponsor need not file a Form 1099-R if the failure is corrected as described in Section 6.07(3). Specifically, Section 6.07(3) requires that: (i) the participant make up any missed loan installment payments with a single sum payment equal to the additional payments that the participant would have made had there been no failure to repay the plan plus interest or (ii) the outstanding balance of the loan be re-amortized, including interest, over the original loan's remaining schedule or the period remaining had the loan been amortized over the maximum period that complies with Section § 72(p)(2)(B).

Section 6.07(2) indicates that the correction method for defaulted loans under Section 6.07(3) is available through VCP. However, Section 6.07(2) does not indicate that VCP is required for the correction method indicated under Section 6.07(3). Nor does Section 6.07(2) state that, absent approval under VCP regarding a failure involving defaulted loans, a Form 1099-R must be filed. In addition, the IRS website (http://www.irs.gov/Retirement-Plans/Retirement-Plan-Errors-Eligible-for-Self-Correction) indicates that loan failures are eligible for self-correction. Does EPCRS require the plan sponsor to submit an application under VCP to utilize the correction method described under Section 6.07(3) and avoid filing a Form 1099-R or may this correction method be used under SCP, provided the other SCP requirements are satisfied?

Proposed Response: Section 6.07(2) provides that the relief from reporting the participant's loan as a deemed distribution on Form 1099-R applies only if the plan sponsor specifically requests such relief and provides an explanation supporting the request. In addition, Section 6.07(2) also provides that the Service reserves the right to limit the use of the correction method described in Section 6.07(3) to situations that it considered appropriate, such as when the loan failure is caused by employer action. As supported by these two statements in Section 6.07(2), the correction method described in Section 6.07(3) is available only through VCP and the relief from the requirement to file a Form 1099-R is available only if the IRS approves a specific request in the VCP application.

IRS Response: The Service representative agrees with the proposed response. The Service representative indicated that the IRS generally agrees that Section 6.07(2) of Rev. Proc. 2013-12 specifically provides that the correction method set forth in Section 6.07(3) relating to defaulted loans are available for plan loans that are corrected through VCP or Audit Cap.

2. § 72(p) – Loan Repayment Period

Section 72(p)(2)(B)(i) states that, to be a permissible loan from a qualified plan, the loan must, by its terms, be "required to be repaid within five years." Neither the Code nor the regulations specifies when the five-year period begins. The regulations state that a loan must be repaid within "five years from the date of the loan." Many recordkeepers, recognizing that there is a lag between the date a participant receives the loan funds and when repayments commence, treat the start of the five-year repayment period as the date the first payment is withheld from the borrower's pay. Does the IRS agree that this is a practical way to meet the requirement in Section 72(p)(2)(B)(i)?

Proposed Response: Yes. It is virtually impossible to make payments over the required five-year period if the period commences on the date the participant receives the loan funds. We agree with the statement in the "Blue Book" for TEFRA that says: "If there are required periodic payments, the first of which is due to be made within two months of the date the loan is made, then [the] five-year repayment period will be measured by the due date of the first payment."

IRS Response: The Service representative disagrees with the proposed response. The IRS representative noted that in the Section 72(p) regulations, both Q&A-3(b) and Q&A- 9(c) basically indicate that the date of the loan is supposed to be specified in the terms of the plan agreement. So, there should be a plan provision that indicates when the five-year period starts running. The Service representative noted that with respect to the five-year period, the start date cannot be after the loan is funded or after the loan proceeds are paid to the participant. At the very latest, that is when the loan starts.

3. § 401 – Correction of Errors

Company A acquired Company B in 2012 through a stock acquisition. In connection with the transaction, Company A also acquired Company B's Section 401(k) plan. In connection with the preparation of the Form 5500, auditors discovered that the Section 401(k) plan had an operational failure. In this scenario, the Company B failed to treat bonuses as "compensation" under the terms of the plan. Based on limited records provided in connection with the acquisition, Company A has determined that this operational failure persisted in 2010 and 2011. The Company does not have access to payroll reports or 401(k) plan election forms for years prior to 2012. It determined that the operational failure occurred in 2010 and 2011 based on documentation that was inadvertently provided to Company A with respect to ten employees. Company A has requested prior payroll records from the seller, but the seller refused to provide the records. Company A is willing to correct the operational failure, but lacks the data to make the corrections. What should Company A do?

Proposed Response: If Company A does not have accurate records to calculate a correction for years prior to 2012, it is not obligated to correct the failure. Company A must correct the failure for 2012 and beyond. On audit, the Service will not take action for years prior to 2012 since Company A does not have sufficient records for the Service to examine these years.

IRS Response: The Service representative disagrees with the proposed response. If Company A does not have accurate records to calculate a correction for years prior to 2012, it should explore obtaining that information from other sources like prior service providers, affected employees, and other reports prepared for other purposes like non-discrimination testing reports. To the extent that there are gaps in information, other options should be explored such as the use of reasonable estimates as provided in Rev. Proc. 2013-12, Section 6.02(5)(a) to correct those years.

4. Section 401 – Determination Letter for New Pre-approved Defined Benefit Plan

Is it possible for a newly adopted defined benefit volume submitter plan to obtain an IRS determination letter for the plan by filing a Form 5307 with respect to the plan other than during the first two years of the six year cycle provided by Section 18.01 of Rev. Proc. 2007-44?

Taxpayer created a new defined benefit plan on December 31, 2013 using a volume submitter plan document, with modifications which are substantive but not so numerous as to put the plan outside the volume submitter program. Taxpayer filed for a determination letter using a Form 5307 on January 31, 2014. The IRS reviewer responded on April 9, 2014 with a letter stating "We are returning the enclosed request for a determination letter because it relates to an issue for which this office is not authorized to issue a determination letter. See Rev. Proc. 2013-6 9.03"

Proposed Response: Because this is a newly adopted plan, not a restatement of an existing plan, the taxpayer's remedial amendment period begins with the date of adoption of the volume submitter plan, and the Form 5307 should be accepted as timely filed. The IRS has announced at numerous meetings and conferences over the past few years that the "Staggered Cycle" system was not intended to prevent taxpayers from getting determination letters on new plans, only to affect restatements of existing plans. Suggesting taxpayers should be required to incur the expense of the creation and review of an individually designed plan for a determination letter is unrealistic and only creates additional review burden for IRS.

IRS Response: The Service representative disagrees with the proposed response. The Form 5307 which is used for substantive modifications that do not put the preapproved plan outside of the volume submitter should only be submitted during the two-year cycle.

5. § 401(a) – One-Time Irrevocable Election

A partnership sponsors a profit sharing plan which is tax-qualified under Section 401(a). The plan contains both a Section 401(k) and profit sharing feature. Upon initial employment, each eligible employee who is a partner (or who may someday become a partner) has the opportunity to make a one-time, irrevocable election to participate or not participate in the profit sharing feature of the plan. Partner A elects to opt-out of the profit sharing feature. Ten years later the partnership adopts a new defined benefit plan for partners only. Participation in the new defined benefit plan is mandatory for all partners under the partnership agreement, to assure compliance with Code Section 401(a)(26). Can Partner A participate in the new defined benefit plan despite his previous opt-out election?

Proposed Response: Treas. Reg. § 1.401(k)-(1)(a)(3)(v) provides that certain one-time irrevocable elections are not treated as cash or deferred elections for purposes of Section 401(k). The regulation further provides that a one-time irrevocable election must be applied to all other plans of the employer, including plans which do not exist at the time of the election. Notwithstanding the foregoing, Partner A's participation in the new defined benefit plan (i) does not violate the prior opt-out election, and (ii) is not an impermissible CODA, because his participation in the defined benefit plan is a mandatory term of employment and no election is involved.

IRS Response: The Service representative disagrees with the end of the proposed response. The beginning of the proposed response cites the regulation that indicates that if a participant makes a one-time irrevocable election, it applies to all plans of the employer and the regulation specifically indicates that that is not limited to plans in the existence at the time of the election. So, the election applies to future plans. The Service representative agrees with that portion of the proposed response. However, the proposed response further states that notwithstanding Treas. Reg. § 1.401(k)-(1)(a)(3)(v), the partner may be a participant in the new plan. The Service representative disagrees with that part of the proposed response.

6. § 401(a)(35) – Divesting of Company Stock

A 401(k) plan makes its matching contribution in the form of stock. Otherwise, stock is <u>not</u> an available investment option for participant direction. Participants, however, can divest out of the stock fund at any time but once a participant elects to move out of the stock fund, he or she cannot reinvest in the stock fund. Does the fact that the employee cannot reinvest in the stock fund violate the requirements under Section 401(a)(35) of the Internal Revenue Code?

Proposed Response: This exact fact pattern is not addressed in the Treas. Reg. §1.401(a)(35). However, the preamble to this regulation provides that "commentators requested that the list for permitted indirect restrictions or conditions be expanded to include certain defined contribution plans that make matching contributions in employer securities and allow participants to divest employer securities attributable to such contributions, but do not permit participants to later elect to reinvest any portion of their account balances in employer stock" but the final regulations did not adopt this suggestion. The preamble further provides that "the inability to reinvest in employer securities generally acts as a material deterrent to an individual who might otherwise have elected to diversify his or her account balance of employer securities." Based on the language in the preamble, the answer is that the fact pattern above (*i.e.*, the inability of the employee to reinvest in the stock fund) violates the requirements under Section 401(a)(35) of the Code.

Commentary Note: It would be extremely onerous for a plan sponsor to retain this feature as it would have to permit an employee to divest his employer matching contributions and later be able to reinvest only matching contributions back into the stock fund. The plan would have to open up stock as an investment option only for matching contributions. It would be preferable for the stock to be treated as a frozen fund – once a participant moves out of the stock fund, he/she cannot reinvest in the frozen fund.

IRS Response: The Service representative agrees the proposed response. It violates Section 401(a)(35) of the Code because it is an indirect restriction on an individual's right to divest employer securities under the regulations and does not meet any of the permitted indirect restrictions or conditions described in the regulations.

7. § 401(h) – Applicability of Excise Tax Upon Reversion after Satisfaction of all Liabilities

Employer established a separate account under its defined benefit pension plan pursuant to Code Section 401(h) (the "401(h) Account") to provide for payment of the employer's costs (and applicable expenses) for retiree medical benefits under its medical plan for retirees. All contributions made to the 401(h) Account were made by the employer in accordance with the requirements of Code Section 401(h). None of the amounts in the 401(h) Account are attributable to transfers of excess pension assets, so the provisions of Code Section 420 are not applicable. Upon satisfaction of all liabilities under the employer's retiree medical plan, any remaining amount in the 401(h) Account will be returned to the employer in accordance with the requirements of Code Section 401(h) and Section 1.401-14 of the Income Tax Regulations. Will the return of the remaining amounts in the 401(h) Account be subject to the excise tax provisions of Code Section 4980?

Proposed Response: No. Code Section 4980 was enacted as part of the Tax Reform Act of 1986 for the reasons set forth in the General Explanation of the Tax Reform Act of 1986 prepared by the staff of the Joint Committee on Taxation (the so-called "Blue Book") (on page 751) as follows:

> Congress believed that it was appropriate to limit the tax incentive available for retirement savings provided through defined benefit pension plan to the <u>amount actually applied to provide retirement income</u>. <u>To the extent</u> that amounts in such plans are <u>not used for retirement purposes and revert to the employer</u>, Congress believed that the tax treatment of reversions should recognize that the tax on earnings on pension funds is deferred and, thus, the benefits of this tax treatment should be recaptured (emphasis added)….

It is clear from the Blue Book that Code Section 4980 was intended to apply to reversions of assets attributable to the provision of retirement income; nowhere was there any mention of Congressional intent to apply the reversion excess tax to returns of amounts in separate accounts under the pension plan contributed pursuant to Code Section 401(h) for the provision of retiree medical expenses.

Code Section 401(h) was added in October, 1962 by Public Law 87-863, to apply for taxable years beginning after the date of enactment. As originally enacted, it provided that the plan must provide by its terms that any amount remaining after satisfaction of all liabilities must be returned to the employer; there is no opportunity for these amounts to be used to provide retirement income. If Congress, in 1986, had intended for Code Section 4980 to apply to amounts in a separate 401(h) account under the pension plan which are returned to the employer pursuant to Code Section 401(h), it easily could have so provided. Therefore, there is no basis to conclude that the excise tax under Code Section 4980 should apply to amounts returned to the employer pursuant to the terms of Code Section 401(h).

IRS Response: The Service representative disagrees with the proposed response. The return of remaining amounts in the Section 401(h) account to the employer would be subject to the Section 4980 excise tax.

8. § 401(k) – Safe Harbor Plan

A 401(k) plan is intended to be a safe harbor plan under Treas. Reg. §1.401(k)-3 and §1.401(m)-3 and uses a basic matching contribution formula to satisfy the ADP and ACP safe harbor requirements. The basic matching contributions are made on a payroll basis. The plan also has a discretionary matching contribution that imposes a last day of the year requirement. The discretionary matching contribution does not exceed 4% of an employee's safe harbor compensation, and the total of matching contributions under the plan is not made with respect to elective deferrals that exceed 6% of the employee's safe harbor compensation. Can the last day requirement be imposed on the discretionary matching contribution provided the discretionary matching contribution is subject to ACP testing without violating the plan's status as a safe harbor plan with respect to the ADP safe harbor, and, solely with respect to the safe harbor basic matching contributions, the ACP safe harbor?

Proposed Response: The plan can impose a last day of the year requirement provided the discretionary matching contributions are subject to the ACP test and further provided the 4% and 6% requirements set forth above are satisfied. This design feature will not cause the plan to lose its status as a safe harbor plan with respect to the ADP safe harbor and ACP safe harbor (as it relates to the safe harbor basic matching contributions).

IRS Response: The Service representative disagrees with the proposed response. The Service representative indicated that the Service thinks it is a problem under the safe harbor. Even though it is discretionary, even if contributions are no more than 6%, with the last day requirement it is possible to have different rates of match for some highly compensated employees and other non-highly compensated employees. As a result, it may raise an issue under the safe harbor requirements.

9. § 401(k)(2)(B)(i) – Hardship Withdrawal Participant Pre-Certification

A 401(k) plan permits participants to receive hardship distributions in accordance with the "safe harbor" rules listed in Treasury Regulations section 1.401(k)-1(d)(3). The plan requires participants to use all other sources of financing before applying for a hardship distribution by submitting a signed "Hardship Withdrawal Form" to the plan. The Hardship Withdrawal Form has several components, including:

- a section requiring participants to select the applicable "safe harbor" hardship event and to specify the participant's relationship to the person experiencing the event;

- a section listing, for each "safe harbor" hardship event, specific documents required to support and substantiate the hardship request;

- a section providing examples of other financial sources that could be used to satisfy the hardship (*e.g.*, insurance proceeds, commercial loans, other asset liquidation, discontinuing plan contributions, etc.); and

- a section explaining the consequences of receiving a hardship distribution (particularly, suspension of elective deferrals).

To complete the hardship withdrawal application process, participants must sign an attestation at the end of the Hardship Withdrawal Form, expressly certifying that (i) the statements provided on the Hardship Withdrawal Form are true and accurate; (ii) the participant exhausted all other available financial sources, including (but not limited to) sources listed as examples; (iii) the requested distribution amount does not exceed the amount of the hardship; (iv) the participant has the required documentation specifically listed in the Hardship Withdrawal Form to substantiate the hardship request; and (v) the participant will maintain, for at least 3 years, the documentation required to substantiate the hardship request.

Can the plan maintain properly completed Hardship Withdrawal Forms in its files as an effective and sufficient internal control designed to prevent compliance issues in hardship withdrawal administration?

Proposed Response: Yes. The plan's hardship withdrawal application process is an effective and sufficient internal control because it provides a formal approval and document maintenance process that adequately ensures that hardship distributions comply with both plan terms and Internal Revenue Code requirements.

IRS Response: The Service representative agrees that the process is an effective and sufficient internal control, provided that reliance on participant's statements is reasonable and the employer has no knowledge to the contrary.

10. § 401(k)(2)(B)(i) – Reinstating Contribution Elections Following Hardship Suspension

A 401(k) plan (that does not have a QACA feature) permits participants to receive hardship distributions in accordance with the "safe harbor" rules listed in Treasury Regulations section 1.401(k)-1(d)(3). As required under Treasury Regulations section 1.401(k)-1(d)(3)(iv)(E)(2), the plan suspends elective contributions and employee contributions for 6 months after a participant receives a hardship distribution. After the suspension, the plan automatically reinstates contribution elections (unless the participant elects otherwise) within 2 pay periods following a 30-day grace period that runs subsequent to the suspension, potentially resulting in a 7-month suspension period.

Will the plan experience an operational failure under EPCRS (*e.g.*, failure to follow plan provisions, missed deferrals) if the plan document provides that participant contribution elections will be reinstated automatically after the six (6) month suspension period?

Proposed Response: The plain text of the cited regulation requires a suspension of "elective contributions and employee contributions to the plan and all other plans maintained by the employer *for at least 6 months after receipt of the hardship distribution*." (emphasis added) If the plan document does not provide expressly for the 30-day grace period, the plan will experience an operational failure if it fails to reinstate participant elections as soon as administratively practicable after the end of the 6-month suspension.

IRS Response: The Service representative agrees with the proposed response. The Service representative noted that there is nothing in the regulations that says suspending for six months plus 30 days plus two pay periods is not permitted. However, if the plan document provides for suspension for six months and there is other added time which is not directly related to administration, then it would be a problem as it would be a failure to follow the terms of a plan.

11. § 402A – Calculation of Tax Period for Roth Contributions

Can the 5-year tax period used to determine if a Roth designated contribution is a qualified Roth distribution continue beyond the date of the participant's death? For example, a participant makes a Roth designated contribution in 2012 and dies in 2014. Can his/her beneficiary take distribution in 2017 (after completion of the 5-year tax period) at which time the distribution becomes a qualified Roth distribution?

Proposed Response: Yes. The clock to determine if the distribution of the Roth designated contribution is a qualified Roth distribution does not stop upon the participant's death. Provided the beneficiary withdraws the distribution no later than the time required by law and the Roth distribution is made after the end of the applicable 5-year period, the distribution of the Roth designated contribution will be a qualified Roth distribution.

IRS Response: The Service representative agrees with the proposed response. The clock to determine if the distribution of the designated Roth account qualifies as a qualified distribution continues to run and does not stop upon the participant's death. Provided the beneficiary withdraws the distribution no later than the time required by law and it is made after the five-year period runs, the distribution would be a qualified Roth distribution.

12. § 402A – Merger of Plan with Roth Contributions

Can a plan that permits Roth contributions be merged into a plan that does not contain a Roth contribution provision? A Roth contribution provision will not be added to the successor plan as a result of the merger.

Proposed Response: Yes. A plan that has a Roth contribution provision can be merged into a plan that does not contain a Roth contribution provision at the time of or subsequent to the merger. However, the Roth contribution feature must be suspended (eliminated) prior to or as part of the plan merger.

IRS Response: The Service representative agrees with the proposed response. The Service representative noted that the surviving plan needs to have provisions that would take into account the existence of the designated Roth account that was in the prior plan. For example, the plan needs to include the distribution rules that would be applicable with respect to the designated Roth account.

13. § 402A(c)(4)(E) – In-Plan Roth Rollovers

Can a qualified plan be designed to limit in-plan Roth rollovers to participants who are 100% vested?

Proposed Response: Yes, assuming the plan design complies with Section 401(a)(4) of the Code.

IRS Response: The Service representative agrees with the proposed response. This analysis is very similar to some of the guidance in IRS Notice 2013-74, which provided that subject to non-discrimination requirements that normally apply to benefit rights and features, a plan may limit the types of contributions that are eligible for in-plan Roth rollovers and the frequency of those rollovers.

14. § 403(b) – Copy of Contract

Is the vendor of a Section 403(b)(1) annuity contract and/or a Section 403(b)(7) custodial account that holds Section 403(b) plan assets required to provide to the plan administrator a copy of each annuity contract and/or custodial account holding plan assets in order that the plan administrator will have sufficient information to determine the policy, account or other number of the arrangement and the terms of each investment arrangement that is incorporated by reference into the Section 403(b) plan?

Proposed Response: Yes, the vendor of each approved investment arrangement provided under the Section 403(b) plan is required to provide to the plan administrator a copy of each annuity contract and/or custodial account holding plan assets in order that the plan administrator will have sufficient information to determine the policy, account or other number of the arrangement and the terms of each investment arrangement that is incorporated by reference into the Section 403(b) plan. The vendor of each approved investment arrangement provided under the Section 403(b) plan is required to provide this documentation in order that the plan administrator will have sufficient information to identify the approved investment arrangements and the terms of such arrangements under the Section 403(b) plan, as described in Revenue Procedure 2013-22.

IRS Response: The Service representative disagrees with the proposed response. There is nothing in Section 403(b) of the Code or the underlying regulations that specifically require vendors to provide plan administrators with copies of annuity contracts and/or custodial accounts that hold a plan asset. However, the Service representative indicated that she believes that it is a best practice for plan administrators and vendors to communicate and share information. This approach generally should be reflected in the agreements between administrators and vendors.

15. § 403(b) – Termination of 403(b) and Contributions to Subsequent 403(b)

Treasury Regulation Section 1.403(b)-10(a)(1) addresses 403(b) plan termination. It provides that an employer may not "make contributions to another 403(b) contract" within a specified time period after terminating a Section 403(b) plan. For purposes of this provision, does forwarding employee salary reduction amounts to a non-ERISA Section 403(b) plan constitute making contributions? In other words, does the regulation prohibit an employer from terminating an ERISA Section 403(b) plan, and immediately establishing a new non-ERISA Section 403(b) plan (no employer contributions)?

Proposed Response: For purposes of this provision, forwarding employee salary reduction amounts alone does not constitute making a contribution to a Section 403(b) contract.

This provision mirrors the provision in the 401(k) plan regulations that prohibits an employer from terminating a Section 401(k) plan and immediately replacing it with another Section 401(k) plan. These rules reflect the principle of plan permanency. A non-profit organization would typically be shifting from an ERISA Section 403(b) plan to a non-ERISA Section 403(b) plan for the purpose of eliminating employer contribution costs and ERISA compliance costs. Imposing a one-year hold out rule would not further the permanency principle, but would impose an unnecessary hardship on employees. While the Section 401(k) regulations may treat employee elective deferrals as employer contributions for certain purposes, employee salary reduction amounts are not "contributions" for purposes of Treasury Regulation Section 1.403(b)-10(a)(1).

IRS Response: The Service representative disagrees with the proposed response. The Service representative noted that the Service is not addressing whether or not there is an ability to transfer any assets from an ERISA plan to a non-ERISA plan.

16. § 409A – Dissolution and Liquidation of Employer

What is the proper interpretation of Treas. Reg. Section 1.409A-3(j)(4)(ix) as it relates to the orderly dissolution and liquidation of a company that is not insolvent and has not suffered a financial downturn? A Delaware corporation, upon approval by its board of directors and shareholders, will file a certificate of dissolution with the state. Under Delaware law, the corporate entity remains intact (although generally it no longer conducts any operating activities) for a three-year period after filing a certificate of dissolution in order to satisfy claims of creditors before a complete liquidation of remaining assets is made and distributed to shareholders. The corporation would like to terminate and pay out deferred compensation accounts upon the filing of the certificate of dissolution (or within the 12 months thereafter) in reliance on Treas. Reg. Section 1.409A-3(j)(4)(ix) which provides in relevant part:

> "(ix) Plan terminations and liquidations. A plan may provide for the acceleration of the time and form of a payment, or a payment under such plan may be made, where the acceleration of the payment is made pursuant to a termination and liquidation of the plan in accordance with one of the following:
>
> (A) **The service recipient's termination and liquidation of the plan within 12 months of a corporate dissolution taxed under section 331**, or with the approval of a bankruptcy court pursuant to 11 U.S.C. § 503(b)(1)(A), provided that the amounts deferred under the plan are included in the participants' gross incomes in the latest of the following years (or, if earlier, the taxable year in which the amount is actually or constructively received).
>
> (1) The calendar year in which the plan termination and liquidation occurs.
>
> (2) The first calendar year in which the amount is no longer subject to a substantial risk of forfeiture.
>
> (3) The first calendar year in which the payment is administratively practicable."
>
> From what point in time is the 12-month period recited in clause (A) measured?

Proposed Response: The 12-month period is measured from the date on which the certificate of dissolution is filed with the state. To conclude otherwise would be contrary to the legal requirement of satisfying all payment obligations to creditors (which would include persons having a legally binding right to deferred compensation) prior to making the final liquidating distribution to shareholders.

Taxation under Code Section 331 applies to distributions in complete liquidation of the corporation in exchange for outstanding shares after all debts have been satisfied, not the dissolution process that begins three years earlier. Consequently, the use of the phrase "dissolution taxed under section 331" is a misnomer that should be corrected via a technical correction.

IRS Response: The Service representative agrees with the proposed response. The language should be interpreted as meaning a dissolution subject to tax under Section 331, thus the 12-month period is measured from the date the certificate of dissolution is filed with the State and is not measured from the date a complete liquidation in exchange for shares of stock has taken place.

17. § 409A – One Time and Form of Payment

May an nonelective account balance plan, as defined in Treas. Reg. Section 1.409A-1(c)(2), provide for a payment of installments over five years if the participant enters the plan after age 50 and installments over 10 years if the participant enters the plan prior to age 50?

Proposed Response: This will not result in more than one time or form of payment and is not a violation of Treas. Reg. Section 1.409A-3(c).

IRS Response: The Service representative agrees with the proposed response. Since a plan is a separate plan as to each participant, the plan will have one term for those entering the plan before age 50 and another term for those entering the plan after age 50. Thus, the plan would not provide for more than one time or form of payment.

18. § 409A – Plan Aggregation

Section 409A does not expressly indicate how restricted stock units ("RSUs") should be treated for purposes of the Section 409A plan aggregation rules. In this regard, please indicate whether the following RSU awards should be characterized as non-elective account balance plans (as defined in Treasury Regulation Section 1.409A-1(c)(2)(i)(B)), elective account balance plans (as defined in Treasury Regulation Section 1.409A-1(c)(2)(i)(A)), or other compensation (as defined in Treasury Regulation Section 1.409A-1(c)(2)(i)(I)) for purposes of the 409A plan aggregation rules:

- A RSU award that qualifies for the short-term deferral exception to Section 409A.
- A RSU award that does not provide the grantee with the ability to select the time of payment. For example, a RSU award that is payable only upon the grantee's separation from service for any reason.
- A RSU award that allows the grantee to elect the time of payment. For example, a RSU award that allows the grantee to elect to be paid shortly following the end of a restricted period or to defer payment until his or her separation from service for any reason.

Proposed Response: The RSUs should be treated as follows:

- The plan aggregation rules do not apply to amounts that are not subject to Section 409A which means that RSU awards that qualify for the short-term deferral exception to Section 409A need not be aggregated for purposes of the plan aggregation rules.
- RSUs are account balance plans for purposes of Treasury Regulation Section 31.3121(v)(2)-1(c)(1)(ii)(A) whereby the principal amount credited to the grantee's account equals the number of shares subject to the RSU award. RSU awards that do not allow the grantee to elect the time of payment are non-elective account balance plans for purposes of the plan aggregation rules.
- Q&A-11 from the 2013 ABA Q&As provides that a grantee's ability to defer payment will not cause an award to be characterized as an elective account balance plan. As applied to this question, this means that a RSU award that allows the grantee to elect the time of payment will also be treated as a non-elective account balance plan for purposes of the plan aggregation rules.

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

19. § 411(d)(6) – Change in Loan Duration

An ESOP with a plan provision that limits the term of a loan to ten years enters into an exempt loan with a term of 20 years. The inconsistency is not discovered until the loan has been amortized for five years. In order to receive an allocation, a participant must be credited with 500 hours of service and be employed on the last day of the plan year. Can the plan be amended prospectively to increase the term of the loan to 20 years?

Proposed Response: Yes, but the plan sponsor will also need to make an additional payment or payments to the ESOP so that the shares that would have been allocated had the loan been for a ten-year term rather than a twenty-year term are allocated to participants who satisfied the requirements for years one through five. Because of the last day and hour of service requirement, there is no Code Section 411(d)(6) cutback by virtue of this amendment prospectively. Also, under these circumstances, the ESOP regulatory requirement that loans be amortized over one of two schedules should not be regarded as violated.

IRS Response: The plan sponsor should file a submission with the IRS under the Voluntary Compliance Program to discuss a correction method with respect to this operational failure. The Service representative agrees that this would not create a Section 411(d)(6) problem unless the amendment is applied to modify the conditions for a participant's receipt of an allocation after the participant has satisfied those conditions. The Service representative also noted that the proposed correction method could be viewed as similar to a refinancing so this could give some rise to some Title I issues.

20. § 411(d)(6) – Plan Termination

Rev. Rul. 85-6 which provides guidance on the requirements of Section 411(d)(6) that a plan not be amended to eliminate or reduce an early retirement benefit discusses this requirement in the context of a defined benefit plan that terminates, while the employer continues, and upon termination provides benefits in the form of cash and annuities. The revenue ruling concludes that, in order to protect the right of participants to grow into the subsidized early retirement benefit where the employer continues, the plan could either purchase annuities providing for the protected benefit or amend the plan to provide the subsidized benefits to all participants without regard to whether they subsequently satisfy the necessary conditions. Please clarify, that notwithstanding the seeming broadness of the ruling and the reference to providing the subsidized benefits to all participants on plan termination, only annuity forms of benefit would be required to satisfy the requirements of 411(d)(6)(B) upon plan termination where the employer continues.

Proposed Response: Where a defined benefit plan terminates, but the employer continues in business, a plan will be deemed to have satisfied Section 411(d)(6)(B) if it offers distribution in the form of an annuity that provides for the subsidized early retirement benefit on the same terms as provided in the plan provided it makes it clear to participants that those who forgo the annuity benefit and instead elect a lump sum option will be forfeiting the right to potentially grow into the subsidized benefit.

IRS Response: The Service representative notes that they do not have enough facts to determine whether or not they agree or disagree with the proposed response. The Service representative noted that the Section 411(d)(6) regulations, § 1.411(d)-4 Q&A-2(a)(2)(i) and in the Examples section, Example 2, clearly indicate that it is not a Section 411(d)(6) violation to offer an employee the choice and have the employee select an unsubsidized lump sum, a benefit based on the normal retirement benefit, versus a subsidized annuity. The key becomes what are the plan terms prior to plan termination? If it offers the choice between a subsidized lump sum and a subsidized annuity then plan termination does not allow the plan to take the subsidy out of the lump sum. But, if the plan offered a choice between an unsubsidized lump sum and a subsidized annuity, the plan can continue to do that. And if the plan did not offer a lump sum at all, so it is adding a new lump sum feature, it can add the lump sum on an unsubsidized basis.

21. § 457(b) – Change of Form of Payment from Plan

A Section 457(b) plan sponsored by a tax-exempt entity allows a participant who has made an initial election to defer compensation pursuant to Treasury Regulation § 1.457(c)(ii)(A) to make one additional election to defer commencement of distributions under the plan before distributions have commenced in accordance with the initial deferral election. Can the plan also permit the participant to use that additional election to change the form of payment from the plan (*e.g.*, by changing from 10 annual installments to a lump sum payment)?

Proposed Response: No. Code Section 457(e)(9)(B) provides that an eligible Section 457(b) plan of a tax-exempt entity may permit a participant to make one additional deferral election after the initial election to defer commencement of distributions. The applicable regulations specifically state that an eligible plan of a tax-exempt employer may provide one additional election to defer "but not accelerate" commencement of distribution. The additional election must be made before the commencement of distributions but after the time such amounts could be made available to participants under Section 457(d)(1)(A). Treas. Reg. § 1.457-7(c)(iii). Thus, the available additional election to defer commencement of distribution may not be used to elect a new form of payment because that would effectively permit the participant to accelerate payments from the plan. Further, the regulations only permit a change in the commencement of distribution. The regulatory language does not permit an additional election of a new form of payment, whether or not such new form of payment would constitute an acceleration. Thus, an additional election of any new form of payment is impermissible, even a change of payment from a lump sum to installments or one that increases the number of annual installments (*e.g.*, from 10 to 20).

IRS Response: The Service representative indicated that they agree with most of the proposed response. The proposed response provides that subsequent elections cannot result in an acceleration of the distribution. The Service representative indicated that they agree with that. The last two sentences of the proposed response seem to suggest that the form of distribution cannot be changed under any circumstances. The Service representative noted that Treas. Reg. § 1.457-7(c)(2)(iv) specifically indicates that the form of payment can be changed. The amount just cannot be accelerated.

22. § 457(b) – Correction of Significant Errors in Plan of Tax Exempt Entity

Section 457(b) plan of a tax exempt employer covering solely the executive director of the employer was established 10 years ago. Several significant operational errors have recently been discovered. EPCRS indicates that Section 457(b) plan corrections will be considered outside of EPCRS but only for governmental employers and that in only very limited circumstances will correction be considered for tax exempt Section 457(b) plans (the only example listed being coverage of rank and file employees by the plan when it should have limited coverage to key management employees). Neither the executive covered by the plan, nor the tax exempt entity were aware that the plan's operations or set up had any problems and no withdrawals from the plan have been made. The errors have only recently been discovered.

<u>Questions relating to assets held in trust</u>: The vendor that established and kept the records for the plan since its inception misunderstood and incorrectly set the plan up as a governmental plan. As a result, all assets have been placed in trust since inception of the plan 10 years ago.

Question 1: Is this a situation that IRS would consider for correction outside of EPCRS?

Proposed Response 1: Yes, the IRS would consider resolution of this situation via a closing agreement outside of EPCRS if the organization and the executive director sign the statement of facts verifying that they were unaware that the assets were not supposed to have been placed in trust.

Question 2: If the IRS would consider a correction, would an available correction be revocation of the trust with the consent of all parties, allowing the funds to return to the possession of the employer and be subject to taxation to the participant under the Section 457(b) rules, as if the plan had been operated correctly from inception?

Proposed Response 2: Yes, the IRS would allow a reformation dissolving the trust and placing the assets back into the ownership of the organization subject to the tax rules of Section 457(b) provided the executive director has not exercised any ownership rights over the trust that are inconsistent with reformation of the arrangement.

Question 3: If the IRS would considered a correction, and revocation of the trust with return of the assets to the possession of the employer is not an acceptable correction, would an acceptable correction be to liquidate the entire arrangement in the current year and treat the funds as taxable to the participant in the current year (eliminating the necessity of dealing with closed prior years, and of amending tax returns for the few open tax years of the participant)?

Proposed Response 3: Yes, the IRS would agree to dissolution of the arrangement and payment of all assets to the executive director in the current year treating the funds as taxable to the executive director in the current year provided the executive director has not exercised any ownership rights over the trust that are inconsistent with reformation of the arrangement. The agreement would eliminate the need to deal with closed years and amending tax returns for the few years that remain open.

Question 4: To the extent that amounts became taxable to the executive, the organization had a reporting and withholding obligation that was not satisfied because of the misunderstanding. Would the IRS agree that the organization satisfy its withholding obligation when the amounts are actually distributed to the executive under the correction agreement?

Proposed Response 4: Yes, the IRS would agree that the organization's obligation to report and withhold taxes would be fully satisfied by reporting and withholding taxes at the time that amounts become payable to the executive under the correction agreement.

Questions relating to contributions to the plan exceeded limits: Contributions to the plan for a few of the years exceeded the Section 457(b) limits, with most of the excess contribution errors being extremely small but in at least one year, the excess contribution was significant.

Question 5: Is this a situation that IRS would consider for correction outside of EPCRS?

Proposed Response 5: Yes, the IRS would consider resolution of this situation via a closing agreement outside of EPCRS if the organization and the executive director sign the statement of facts verifying that they were unaware of the contribution limits that applied to Section 457(b) plans.

Question 6: If the IRS would consider a correction, would an available correction be reallocation of the contributions to the succeeding year until the excess is used up?

Proposed Response 6: Yes, contributions could be reallocated to succeeding years until excess contributions are used up. If the arrangement is terminated before all excess contributions are used up, then all remaining excess contributions would become taxable to the executive director on the date of termination.

Question 7: If the IRS would consider a correction but reallocation of the excess contributions to the succeeding year is unacceptable, would an acceptable correction be retention of the tax exempt status for the portion of the contribution that was made that did not exceed the limit and taxation to the executive of the portion of the contribution that was too large?

Proposed Response 7: Yes, the tax exempt status of the Section 457(b) arrangement would be left intact as to the amount of contribution that was allowable for each year with only the excess contribution being taxable to the executive.

Question 8: If the IRS would considered a correction, and the only acceptable correction is taxation to the executive of either the excess contribution, or of the entire 457(b) benefit, would an acceptable correction be to liquidate and distribute the portion of the arrangement that needs to be taxed to the executive in the current year and treat the funds as taxable to the participant in the current year (eliminating the necessity of dealing with closed prior years, and of amending tax returns for the few open tax years of the participant)?

Proposed Response 8: Yes, the IRS would agree to a full current liquidation of the entire arrangement taxing all amounts in the arrangement to the executive in the current year and would not require the executive to attempt to open closed years or to file amended tax returns for the few open years.

Question 9: To the extent that amounts became taxable to the executive, the organization had a reporting and withholding obligation that was not satisfied because of the misunderstanding. Would the IRS agree that the organization satisfy its withholding obligation when the amounts are actually distributed to the executive under the correction agreement?

Proposed Response 9: Yes, the IRS would agree that the organization's obligation to report and withhold taxes would be fully satisfied by reporting and withholding taxes at the time that amounts become payable to the executive under the correction agreement.

IRS Response: Section 4.09 of Revenue Procedure 2013-12 allows some tax exempt eligible plan sponsors under limited circumstances to submit requests for voluntary correction under Section 457(b). Voluntary compliance has the complete discretion on whether or not to accept or reject these requests. Based on the language in Section 4.09, the Service generally will not enter into an agreement to resolve the issues of an unfunded, non-qualified deferred compensation plan established for the benefit of top-hat employees of a tax-exempt organization. In this case, the Section 457(b) plan is established solely for the benefit of one executive and is not the kind of plan the Service would consider on a provisional basis.

23. § 457(b) – Impermissible Plan Sponsor

If a church has impermissibly sponsored a Section 457(b) plan, what type of correction should be used?

Proposed Response: Under Code Section 457(e)(13), a church is not an eligible employer and may not sponsor a Section 457(b) plan. A church that has impermissibly sponsored a Section 457(b) plan should cease making contributions to the Section 457(b) plan and should request to enter into a closing agreement with the IRS. Such a closing agreement can be entered into under the informal closing agreement process available for matters not covered under EPCRS. Under the closing agreement, the plan assets would be permitted to remain in the plan on a tax-deferred basis until all plan assets are distributed in accordance with the terms of Code Section 457(b). However, no new contributions may be made to the plan and no new participants may be permitted to participate in the plan.

IRS Response: The Service representative agrees that under Section 457(e)(13) a church is not an eligible employer and cannot sponsor a Section 457(b) plan. The Service representative noted that the Service allows correction of some Section 457(b) plans on a provisional basis. The church should make a voluntary submission to request a closing agreement. The Service will consider, based on all of the facts and circumstances, whether it is appropriate to enter into the closing agreement. The Service will consider whether the plan was erroneously established to benefit the entity's non-highly compensated employees and whether the plan was operated in a manner similar to a qualified plan.

24. § 4980H – Applicable Large Employer Determination–130 Hours Per Month Equivalency

The final regulations define an Applicable Large Employer (ALE) with respect to a calendar year as "an employer that employed an average of at least 50 full-time employees (including full-time equivalent employees) on business days during the preceding calendar year." Generally, an employer's status as an ALE for a calendar year is determined by adding the total number of full-time employees for each calendar month in the preceding calendar year and the total number of full-time equivalent employees for each calendar month in the preceding calendar year, and dividing by 12.

The final regulations define a full-time employee with respect to a calendar month as "an employee who is employed an average of at least 30 hours of service per week with an employer." The regulations also provide that 130 hours of service in a calendar month is treated as the monthly equivalent of at least 30 hours of service per week; this 130 hours of service monthly equivalency applies for both the look-back measurement method and the monthly measurement method for determining full-time employee status.

May an employer use the 130-hour monthly equivalency to identify full-time employees for purposes of determining whether it is an ALE? Must an employer treat an employee as full-time if the employee <u>either</u> averages 30 hours per week during a calendar month <u>or</u> is credited with a total of 130 hours during the calendar month?

Proposed Response: An employer may use the 130-hour monthly equivalency to identify full-time employees for purposes of determining whether it is an ALE. An employer is not required to test an employee's full-time status using both the 30-hour weekly average and the 130-hour monthly equivalency. Rather, the employer can apply the weekly average to some employees and the monthly equivalency to other employees, provided that it does so on a reasonable and consistent basis. An employee will be considered to be full-time only if the employee is credited with sufficient hours under the standard (30 hours per week or 130 hours per month) that the employer is applying to that employee.

IRS Response: The Service representative disagrees with the notion of using either the 130-hour monthly equivalency or 30 hours per week for the applicable large employer determination. For the applicable large employer status, an employer does not use 130 hours. The statute requires employers to use 120 hours. So, for purposes of counting employees for purposes of the large employer determination, an employer counts how many employees worked at least 120 hours in a month. Each employee who works at least 120 hours counts as one full-time employee. It does not matter if the employee worked 121 hours or 250 hours that month, the employee counts as one employee. For employees who did not work 120 hours in that month, the employer counts the employee as a fraction, where the numerator is the employee's actual hours for the month. The denominator is 120. This is prescribed by statute.

The statute uses 30 hours per week when it addresses who is a full time employee for purposes of the payment. For purposes of the applicable large employee determination, neither 130 hours nor 30 hours per week is a relevant concept. The statute uses 120 hours, which is similar, but not the same.

For purposes of the look-back measurement period, the way the statute defines full-time employee for purposes of the assessable payment is an employee who averages 30 hours per week in a month. Months, however, do not ever come out to exactly four weeks. If a month is 31 days, it is 4 and 3/7th weeks. The Service representative indicated that they considered whether this should be applied on that basis and so there would be more hours in a 31-day month. It is discussed in the preamble as to why the Service rejected that approach. It adds a lot of extra administrative burden and complexity and inconsistency with no commensurate benefit. Therefore, for purposes of determining if an employee is full time, an employer uses 130 hours a month. That is the only standard. An employer does not try to apply the 30 hours a week depending on the number of days in a month. This applies for both the look-back measurement and for the monthly method.

25. § 4980H – Determining Whether a New Employee is a Variable Hour Employee

The final regulations include factors for determining whether a new employee is reasonably treated as a full-time employee (expected to average 30 or more hours per week during the initial measurement period), a part-time employee (expected to average less than 30 hours per week during the initial measurement period), or a variable-hour employee (uncertain whether the employee will average more or less than 30 hours per week). The factors include the terms of an employment contract or job description. But the regulations also state that the employer may not take into account the likelihood that the employee may terminate employment before the end of the initial measurement period.

If the terms of the employment contract provide for termination before the end of the initial measurement period, can the employer "take into account that the employee may terminate employment before the end of the initial measurement period?" What if there is some other restriction (such as the expiration of a work visa) that will make it impossible for the employee's employment to continue through the end of the initial measurement period?

Proposed Response: The employer can take into account the provisions of an employment agreement—including the term of the employment agreement—in determining whether an employee is a variable hour employee. Thus, if the term of the employment agreement is shorter than the initial measurement period, the employer can take into account only hours worked during the term of the employment agreement in determining whether the employee is likely to average 30 or more hours per week during the initial measurement period. Similarly, an employer may take into account other facts and circumstances (such as expiration of a work visa) in determining whether an employee will terminate employment before the end of the initial measurement period.

The purpose of the prohibition on taking into account the likelihood of termination of employment is to avoid making assumptions about employees in positions with high turnover, which would penalize employees who are working full-time hours throughout the initial measurement period. This concern is not present when the employment is of a fixed duration, either by agreement or by operation of law. If an employer entered into serial short-term employment agreements to try to avoid treating an employee working more than 30 hours per week as a variable-hour employee, then the facts and circumstances would preclude the employer from treating the employee as a variable hour employee because, considering "the extent to which the hours of service of employees in the same or comparable positions have actually varied above and below an average of 30 hours of service per week during recent measurement periods" would lead to the conclusion that these contracted employees are full-time employees.

IRS Response: The Service representative disagrees with the proposed response. The terms of an employment contract can be relevant in terms of how many hours a week does the employer expect the employee to work while employed, whatever period that is. If the employer does not know if the hours worked are going to be above 130 hours a month or not then the employer can treat them as variable. If an employer hires an employee who is going to work 40 hours a week, but the employer only expects the employee to be employed for six months, so it is going to come out to 20 hours a week for the first year, an employer cannot treat the employee as part time.

There are a couple of points to remember in these situations. First, if the employee is seasonal rather than just part time, meaning that this tends to be a recurring situation, that an employee's employment is tied to a season, special rules apply. An example of a seasonal employee is a life guard or a ski instructor, but it does not have to be someone whose job is affected by the weather directly. It can just be someone who is peak season working in a hotel or something like that or a summer associate at a law firm for that matter. If the employee is seasonal, which cannot be more than six months and is tied to a time of the year, then an employer gets to use the one-year initial measurement period for determining if the employee is full time. If the employee is simply on a short-term contract, the employer cannot do that. An employer always has until the beginning of the fourth month to get employee into the plan. So, if the employee was a short term employee, meaning the employee is only going to be employed for two months, then the employer will not have to bring the employee into the plan.

26. § 4980H – Length of Initial and Standard Measurement Periods

The final regulations state that an employer may choose an initial measurement period "of no less than three consecutive months and no more than 12 consecutive months." The term standard measurement period means a period "of at least three but not more than 12 consecutive months that is used by an applicable large employer member as part of the look-back measurement method." The final regulations do <u>not</u> state that the initial measurement period and the standard measurement period must be the same length, but this seems to be implicit in the operation of the look-back measurement method.

May an employer have different length initial measurement periods and standard measurement periods that apply to same category of employees? For example, could the employer have 6-month initial measurement periods and 12-month standard measurement periods? The idea of having more frequent initial measurement periods would be to give new variable-hour employees more opportunities to qualify for plan coverage, while allowing ongoing employees to lock-in full-time status during a longer stability period.

Proposed Response: The initial measurement period and the standard measurement period must be the same length. The proposed arrangement (6-month initial measurement period and 12-month standard measurement period) is not consistent with the final regulations because it would require new variable hour employees to complete more than one initial measurement period before they completed a standard measurement period. Note that the employer can accomplish the result it wants using a 12-month initial measurement period because the initial measurement period is used only to determine whether an employee is treated as a full-time employee for purposes of Code § 4980H. This determination is separate from the determination of eligibility for the employer's plan. So, this employer could measure an employee's hours during the first six month of employment and extend an offer of coverage to employees with full-time status without Code § 4980H implications. *See* Treas. Reg. § 54.4980H-3(f)(2)(ii), Example 1, for an example of an "early" offer of coverage.

IRS Response: The way the regulation is set up is that it provides that the stability period has to be the same. There is a reason that it is tied to the stability period and it does not say the exact same thing for the measurement period. The reason is that there is a special rule for new employees. Basically, once an employer has the stability periods the same for a new employee and for an ongoing employee, an employer cannot keep someone out if the employee is determined to be part-time during a measurement period. An employer cannot keep an employee out generally for longer than the measurement period. So, once the employer has the stability periods the same, it is generally going to have to have the measurement periods the same for the new variable hour employees and for the ongoing employees in the same category. For example, if an employer applies a look-back measurement for all its hourly employees, it would have to use basically the same measurement period.

However, there is a special rule for new employees that allows the measurement period to be a month shorter than the stability period. The Service representative noted that the reason they did this is that when an employer is dealing with new variable hour employees, the employer has to comply with three constraints. First, the measurement period cannot be longer than 12 months. Second, the administrative period cannot be longer than 90 days. The administrative period is the period between when the employer measures and when it gets people into the plan. An employer has to comply with both of those constraints, but the employer also has to comply with an overall constraint that it must get an employee who is full-time during the initial measurement period into the plan by the beginning of the 14th calendar month or potentially face an assessable payment.

In order to give employers who are subject to these constraints a little bit more time for the administrative period, an employer can use an 11-month initial measurement period. That can give an employer two and a half months in effect for its administrative period and then when it brings people into the plan and it can apply a 12-month stability period. So, that is why the regulation is set up in terms of the stability period being the same, rather than stating that the measurement period has to be the same. But, the effect is the measurement period basically has to be the same except for this one month rule.

27. § 4980H – Monthly Measurement Method–Full-time Employee First Otherwise Eligible

The final regulations provide a special rule under the monthly measurement method for an employee who is first otherwise eligible for an offer of coverage. This rule states that an employer is not subject to an assessable payment under Code § 4980H(a) with respect to an employee for each calendar month during the period of three full calendar months beginning with the first full calendar month in which the employee is otherwise eligible for an offer of coverage under a group health plan of the employer, provided that the employee is offered coverage no later than the first day of the first calendar month immediately following the three month period if the employee is still employed on that day. Moreover, an employer meeting these requirements will not be subject to an assessable payment under Code § 4980H(b) if the coverage provides minimum value.

An example in the final regulations (Treas. Reg. § 54.4980H-3(c)(5), Example 1) posits that an employee is hired into a part-time position for one full calendar year. Then, the employee transfers to a full-time position that is eligible for an offer of coverage under the employer's plan, and the employee is actually offered minimum value coverage under the employer's plan on the first day of the fourth calendar month after transfer to the full-time position. The example concludes that the employer is not subject to Code § 4980H penalties for the first three calendar months after the change to full-time status because the employer offered the minimum value coverage within the timeframe required by the rule. The example also concludes that the employer is not subject to Code § 4980H penalties for the first year of employment because the employee was not a full-time employee.

How would the conclusions in the example be different if the employee had worked the first full calendar year as a full-time employee (not as a part-time employee as in the example) but was not eligible for the employer's plan for the first calendar year of employment due to failure to satisfy a substantive eligibility condition (*e.g.*, because the employee had not yet obtained a required professional license)? (Assume that the employee satisfies all substantive eligibility conditions as of the first day of the second calendar year of employment, as in the example in the final regulations.)

Proposed Response: The employer would potentially be liable for Code § 4980H penalties starting with the employee's first month of employment since the employee became a full-time employee under the monthly measurement method starting with that month. Whether the employer is actually subject to penalties for any month will depend on whether the employer receives a Section 1411 certification for that month.

However, once the employee satisfies all substantive eligibility conditions on the first day of the second calendar year of employment, the employee is now "first otherwise eligible" under the terms of the employer's plan. Thus, so long as the employer offers coverage to the employee by the first day of the fourth month, and so long as the coverage for which the employee was otherwise eligible during the first three calendar months provided minimum value, then the employer would not be subject to Code § 4980H penalties to the same extent as the employer in Example 1.

IRS Response: As long as you bring the employee in by the fourth month in the second year the employer will get a pass for those first three months in the second year. Note that there is no pass for the first year. This is an employee who wasn't full time or the employer did not expect the employee to be full time or the employer is willing to make the payment if they go to the exchange. There is no pass for the first year, but the employer does get the three months whenever the employee first becomes otherwise eligible.

28. § 4980H – Crediting Hours of Service

Rhealth is a hospital and an applicable large employer. Rhealth requires certain of its employees, including nurses to be on-call from time to time. While on-call, employees are paid $3.00 per hour. During their normal hours, the same employees receive compensation at a much higher rate, for example, at $47.00 per hour. While on-call, employees are not required to be on the employer's premises. However, the employees are required to stay close to home, are not permitted to consume alcoholic beverages and must comply with certain other restrictions. For purposes of calculating these employees' hours, is it reasonable for Rhealth to credit either a partial hour for each hour that an employee is on-call (*e.g.*, 0.5 or 0.3 hour for each hour that the employee is on-call)?

Proposed Response: The preamble to the final regulations, under Section 4980H, provides that employers of employees who have on-call hours are required to use a reasonable method for crediting hours of service that is consistent with Section 4980H. Further, the preamble provides that it is not reasonable for an employer to fail to credit an employee with an hour of service for any on-call hour for which payment is made or due by the employer.

Under Rhealth's standard, employees are paid a nominal amount during on-call hours. Employees also do not have to be on the Employer's premises and their activities are only partially restricted. Rhealth is not required to credit a full *hour of service* for on-call hours. Employer is not failing to credit any hours of service, but is crediting less than an hour of service. The regulations provide examples of other categories of employees whose hours are difficult to credit. In particular, the regulations provide that pilots and flight attendants may be credited with only 8 hours of service for each day an employee stays away from home (16 hours total for the two days encompassing an overnight stay). Similarly, employers can credit adjunct faculty with 2¼ hours for each hour of class instruction (regardless of the actual hours of preparation spent by the faculty). The standard used by RHealth is comparable. Employees are not performing any services and receive only a nominal amount of compensation for on-call hours. Employees are not significantly restricted from their daily activities. The standard otherwise does not have the effect of characterizing as non-full-time employees in a position that is traditionally full-time (or 30 hours of service per week). Employer's scheme is reasonable.

IRS Response: The Service representative disagrees with the proposed response. Under the regulations, on-call hours are a difficult issue because on the one hand the employee is not actually working. On the other hand, the employee's ability to go and do the employee's own stuff is kind of constrained and it may be more or less constrained depending on the facts. The regulations state that this is generally a facts and circumstances test, but if the employee is getting paid for the on-call hours (it doesn't matter how much) or if the employee must be on the employer's premises or if the employee is subject to sort of severe restrictions on what the employee can do, the employee must receive credit for the hours of service for the on-call time. So under these facts, the employer would have to credit hours of service. There is no concept of partial hours.

29. § 4980H(c)(4)(B) – Monthly Measurement Method

For purposes of the employer shared responsibility provisions, the final regulations permit the use of the monthly measurement method under which an applicable large employer may determine each employee's status as a full-time employee by counting his or her hours of service for each calendar month. 26 C.F.R. § 45.4980H-3(c)(1). For example, using the monthly measurement period, an applicable large employer that determines that a new variable-hour employee is a full-time employee and is first eligible for health coverage in Month 1 can, consistent with the rule in 26 C.F.R. § 54.4980H-3(c)(2), avoid potential penalties by offering coverage that provides minimum value to that employee no later than the first day of Month 4. What method can the employer use for determining the full-time status of the variable-hour employee going forward?

Proposed Response: The employer can use the look-back measurement method to determine the variable-hour employee's ongoing full-time status beginning with the first full standard measurement period during which the employee is employed.

IRS Response: The Service representative noted that the question seems to assume that the employer is applying both the monthly method and the variable hour method to the same person and the employer cannot do that. You can apply either the hourly method or the look-back measurement but you cannot apply two different methods to the same category and certainly not to the same individual.

30. § 7476 – Notice to Interested Parties

A retirement plan for employees that were previously covered by a collective bargaining agreement is being submitted for a favorable determination letter. The plant that employed the bargained employees has closed. No employees are currently accruing benefits under the Plan. The employer has non-bargained employees who are employed in a different state and are not covered by the planf. Is the employer required to provide a notice to interested parties in connection with the favorable determination letter submission? If so, who should receive the notice?

Proposed Response: The employer is not required to provide a notice to interested parties. Treas. Reg. § 1.7476-1(b)(4) states "all present employees covered by a collective bargaining agreement pursuant to which the plan is maintained shall be interested parties." In this scenario, the employer does not have any present employees covered by a collective bargaining agreement. Treas. Reg. § 1.7476-1(b)(1) provides a general rule on who should receive the notice to interested parties. In this scenario, there are no present employees of the employer whose principal place of employment is the same as the principal place of employment of any employee who is eligible to participate in the plan. In completing the Form 5300 for the Plan, the employer should check "yes" on line 7 indicating interested parties have been given the required notification of the application. Failure to check "yes" on line 7 of the Form 5300 will result in the submission being returned.

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