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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 11, 2007. The statements contained herein cannot be relied on even though they are printed as statements of the IRS. The questions were submitted by ABA members, and the responses were given at such meeting after explicit statements that their responses reflect the unofficial, individual views of the government participants as of the time of the discussion, and do not necessarily represent agency policy. This report on the responses was prepared by designated JCEB representatives, based on the notes and recollections of the JCEB representatives at the meeting and on a review of audio tapes of the meeting. This report has not been reviewed by IRS or Treasury. The questions were submitted in advance to the agency, and it was understood that this report would be made available to the public.

1. § 104(a)(3), § 105, § 106, § 409A – Post-Retirement Health and Medical Benefits and Nonqualified Deferred Compensation

Employer maintains a contributory, self-insured medical plan under which all benefits are financed by employee contributions (including employer contributions which are included in the income of eligible employees). A former employee may continue coverage under the plan after separation from service and until his death provided he continues to pay the required premium on an after-tax basis. Only former employees who were highly compensated individuals may participate in the plan. Are medical care reimbursements under the plan subject to Code § 409A?

Proposed Response: No. Benefits payable under the plan are excludable from the income of recipients pursuant to Code § 104(a)(3). See Treas. Reg. § 1.104-1(d). Because the plan is not financed through pre-tax employer contributions, Code § 105 and the nondiscrimination requirements of Code § 105(h) are not applicable in determining the taxation of benefits under the plan. Code § 409A does not apply to amounts which are excludable from income under Code § 104(a)(3), 105, or 106.

IRS Response: The Service representative agrees that if the benefits are non-taxable because they come exclusively from employee contributions, the arrangement would not be subject to Code § 409A.

2. § 105 – Health Reimbursement Arrangements

Corporation A maintains a health reimbursement arrangement (HRA) that allows for reimbursement of a participant's and a participant's eligible dependents (as defined under Code § 152, including the participant's spouse) medical expenses as defined under Code § 213(d) after the participant has a severance from employment. The HRA provides that after the participant dies, the HRA will continue to reimburse the qualified medical expenses of the participant's eligible dependents. The HRA also provides that if an amount remains after the eligible dependents die, the amount will be forfeited. Do the HRA's restrictions on which expenses are eligible for reimbursement satisfy the requirements under Code § 105? If an amount remained after the participant's dependents died and the employer paid an amount to the participant's beneficiary (or estate) because there was a remaining amount, does that disqualify the tax-favored character of reimbursements under the HRA? If an amount remained after the participant's dependents die and the employer purchased an annuity or life insurance benefit and transferred it to the participant's beneficiary, does that disqualify the tax-favored character of reimbursements under the HRA? If forfeiture is required, is this because the HRA is a form of insurance and that to obtain the tax-favored treatment the participant must have a risk of loss?

Proposed Response: If the employer and HRA did not make any payments or allow for reimbursement after the death of the participant and the participant's dependents, then the structure of the HRA would satisfy Code § 105. If, however, an amount remained after the participant and the participant's dependents die and the employer either (i) paid an amount to the participant's beneficiary (or estate) because there was a remaining amount, (ii) purchased an annuity or life insurance benefit and transferred it to the participant's beneficiary, or (iii) made any other payment or transfer of property because there was a remaining amount, then the HRA would not satisfy Code § 105 and all reimbursements under the HRA would lose their tax-favored status. See Rev. Rul. 2006-36, 2006-36 I.R.B. 353, 354 (Sept. 5, 2006) ("An HRA does not qualify for the exclusion under § 105(b) if any person has the right to receive cash or any other taxable or non-taxable benefit under the arrangement other than reimbursement of medical care expenses."); IRS Notice 2002-45, 2002-28 I.R.B. 93, 93 (July 15, 2002) ("Arrangements formally outside an HRA

that provide for an adjustment of an employee's compensation or an employee's receipt of any other benefit will be considered in determining if the arrangement is an HRA and whether the benefits are eligible for exclusion under §§ 106 and 105(b)."). Forfeiture is required because the HRA is a form of insurance and to obtain the tax-favored treatment the participant must have a risk of forfeiture.

IRS Response: The Service representative agrees an HRA would not satisfy Code § 105 if after the participant and participant's dependents die, the remaining amount in the HRA (1) is paid to the participant's beneficiary, (2) is used to purchase an annuity or life insurance benefit or (3) is used to make any other payment or transfer of property. The Service representative disagrees that a forfeiture is required because an HRA is a form of insurance. Rather, forfeiture is necessary because Treas. Reg. § 1.105-2 provides that if amounts can be received other than for medical care of the employee or the employee's spouse or dependent, the exclusion of Code § 105(b) does not apply. In other words, for this arrangement to be a health reimbursement arrangement, the benefit can only be paid if there are medical expenses.

3. § 105(h) – Self Insured Medical Reimbursement Plans

Is an arrangement like the one described in Revenue Ruling 61-146, under which an employer agrees to reimburse an employee for premiums on an individual health insurance policy purchased by the employee, a "self-insured medical reimbursement plan" under Code § 105(h)?

Proposed Response: No. The benefits that are promised under such an arrangement are the benefits under the policy, which are fully insured. The reimbursement arrangement is merely the method that is used by the employer to pay the premiums.

IRS Response: The Service representative agrees with the proposed response that this is not a self-insured medical reimbursement arrangement.

4. § 106 – Contributions by Employer to Accident and Health Plans

Under Treas. Reg. § 1.125-4(c)(iv), an employee can increase his/her salary reduction election to pay the COBRA cost for his/her divorced spouse or child ceasing to qualify as a dependent under the plan where the divorce or loss of dependent eligibility status is a COBRA qualifying event. If the employer provides a nondiscriminatory non-elective contribution toward the COBRA coverage of that former spouse or former eligible dependent, is that non-elective employer contribution also excluded from the employee's gross income under Code § 106?

Proposed Response: That there is an employer-provided subsidy does not change the result. The amount of the subsidy is not taxable to the employee under Treas. Reg. § 1.61-21(b)(1).

IRS Response: The Service representative disagrees with the proposed response. Whether the coverage is excluded depends on whether the dependent ceased being a dependent under the tax code or ceased being a dependent under the plan's definition of dependent. If the individual is no longer a dependent under the tax code, then coverage for the individual's medical expenses is includable in the employee's compensation. If the individual is still a dependent under the tax code, but no longer a dependent under the plan (*i.e.*, the individual has aged out of coverage), then the coverage would be excludable from the employee's compensation.

5. § 106, § 451 – Contributions by Employer to Accident and Health Plans: VEBAs

Will mandatory employee contributions, made during active employment to a VEBA, which is set up to provide reimbursement of health expenses to the employees after retirement, be taxable income to the employees at the time of the contribution? The contributions are negotiated in collective bargaining agreements as mandatory for the entire bargaining unit; there is no election on the part of an individual employee to make the contribution, to elect the amount, or to invest the contributions. The employee can never have a refund of the contributions. The employee will be entitled only to receive health expense reimbursements from the VEBA after retirement.

Proposed Response: No, the mandatory contributions will be excludable from gross income, under principles of constructive receipt under Code § 451; and – to the extent the contributions are mandatory – will be treated as excludable employer contributions to a health plan under Code § 106.

Revenue Ruling 2002-27 deals, in part, with employees who could not opt out of automatic enrollment for a group health plan, paid for with the employee's pretax contribution from salary because the employer did not collect from the employees any information on other health coverage. Although the plan could not be treated as a Code § 125 plan, the IRS explained that the pre-tax treatment under Code § 106 would not change.

In TAM 6504293220A (April 29, 1965), a collective bargaining agreement provided for a group insurance plan and periodic cost-of-living increases to employee wages. The agreement also required that the first 1¢ per hour of any cost-of-living increase was to be paid into a special fund to offset increases in the cost of group insurance benefits. The TAM noted that “no employee has any individual right or claim to the fund. It is also apparent that an employee does not have the option to have the 1¢ per hour increase paid to him as earned rather than having it paid into the fund.” The TAM concluded from these circumstances that:

[A] holding that it was the intention of the contracting parties that the first 1¢ per hour increase to be paid into the fund is the employer's contribution would not be an unreasonable interpretation [of the collective bargaining agreement]. We now so hold.

See also PLR 199952028 (September 29, 1999), which held that contributions of a specific dollar amount, as set forth in a collective bargaining agreement, to be set aside exclusively to provide “Supplemental Benefits...only for the payment of medical care” for employees, retirees and their spouses and dependents, will be excludable from the participants' gross income under Code § 106(a). Likewise in PLR 9323006, the Service held that where an employer decided to pay accumulated sick leave credit to its retiring employees in the form of supplemental medical benefits, and such employees had no option to receive such credit in cash, such payments did not constitute a taxable event to its retirees, under Code § 451.

In PLR 200007021 (November 19, 1999), a collective bargaining agreement that required the employer to provide health and welfare benefits to covered workers was modified to implement a supplemental health plan (which qualified as a VEBA). The agreement as modified required signatory employers to make contributions to the supplemental plan on behalf of bargaining unit employees equal to a stated amount for each hour worked under the agreement. The employees were then permitted to elect periodically between various benefits provided under the supplemental plan, including a “Premium Account” that was used to fund health insurance premiums for the employees and their qualifying dependants. It was noted that “no individual will be able to elect to receive cash in lieu of contributions.” The Service therefore held that insofar the participants chose

to direct the supplemental contributions toward payment of health insurance coverage provided through the plan, the contribution amounts were excludable from the participants' gross income under Code § 106.

In Rev. Rul. 75-539, the Service held that where an employer places the value of sick leave in an account solely for the payment of health insurance upon retirement, and provides that the amounts may not, in any event, be received in cash by the employee/retiree, the amounts will be considered employer contributions to an accident or health plan and excludable from the retiree's income under Code § 106. (Conversely, the Ruling also held that sick leave would be considered as taxable compensation where the employee had the option to take it in cash: "Unused sick leave credits that are received in cash are includible in gross income under section 61 of the Code as compensation for services.") See also PLR 9840006 (mandatory sick leave transfer to a pension plan is a non-taxable event); and PLR 91040050 and PLR 200027044 (the conversion of unused sick leave to supplemental pension benefits was not current taxable income to participants, even though the contributions would result in a deferral of compensation.)

Likewise in PLR 9323006, the Service held that where an employer decided to pay accumulated sick leave credit to its retiring employees in the form of supplemental medical benefits, and such employees had no option to receive such credit in cash, such payments did not constitute a taxable event to its retirees, under Code § 451.

IRS Response: The Service representative agrees with the proposed response. Based on the facts presented, the Service representative agrees that this plan design meets the requirements of Notice 2002-45.

6. § 125 – Cafeteria Plans: Dependent Care

Husband has elected a \$5,000 dependent care flexible spending account (FSA) through his employer's Code § 125 cafeteria plan. Husband's employer runs mid-year nondiscrimination tests and ceases husband's contributions to his dependent care FSA. Is wife permitted to elect a dependent care FSA under her employer's Code § 125 cafeteria plan for the remainder of the year?

Proposed Response: Yes, provided wife's employer permits mid-year changes on account of and corresponding with a change made under another employer's plan. See Treasury Regulation § 1.125-4(f)(4).

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

7. § 125, § 129 – Dependent Care Expense Reimbursement Under a Cafeteria Plan

The husband of a married couple works at Corporation A and his wife works at Corporation B. Corporation A and Corporation B each maintain a calendar-year cafeteria plan that allows eligible employees to elect to have up to \$5,000 deducted from pay and contributed to a dependent care reimbursement account under a cafeteria plan. At open enrollment, both the husband and wife elect to have \$5,000 deducted from pay to be contributed to the dependent care reimbursement account under the applicable cafeteria plan. After the start of the calendar year, the husband and wife realize that they have elected to have too much contributed to a dependent care reimbursement account. May one spouse (either the husband or wife) ask the applicable employer to revoke that spouse's election to have \$5,000 deducted from pay to be contributed to the dependent care reimbursement account?

Proposed Response: One spouse may ask the applicable employer to revoke the election, if that spouse documents that each of the spouse's elected to have \$5,000 deducted from pay to be contributed to the dependent care reimbursement account. This is permitted because the spouses made a mistake of fact regarding the maximum amount that may be reimbursed under Code § 129. Also, allowing an employer to cancel the election assures the proper FICA and FUTA taxes are imposed. Although a spouse's employer may allow the spouse to cancel such an election, the employer is not required to cancel the election.

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

8. § 125(f) – Qualified Benefits: Long-Term Care Insurance

May employers assign certain executives to either (a) a class of executives with higher pay and no long-term care insurance or (b) a class of executives with lower pay, but with long-term care insurance, without violating the prohibition on voluntary employee pre-tax contributions for long-term care insurance premiums under Code § 125(f)? May employers permit employees to make "one-time elections" to be assigned to one class or the other without violating Code § 125(f)?

Proposed Response: Under Code § 125(f), long-term care insurance (LTCI) coverage is specifically excluded from the definition of qualified benefits that may be offered under a cafeteria plan. As a result, premiums for LTCI may not be made on a pre-tax basis. Therefore, an employer may not permit an employee to elect to receive either a taxable bonus or, in lieu thereof, a non-taxable LTCI premium payment, because this would, in effect, be a prohibited pre-tax compensation reduction election. However, in the situation described above where a class of executives is assigned to or elects either a higher pay/no long-term care insurance coverage or a lower pay/long-term care insurance coverage, no pre-tax amounts are being spent on long-term care insurance. For example, if an employer employs two executives with compensation packages worth \$100,000, one receiving his or her entire compensation in the form of cash, and the other receiving his or her compensation in the form of \$90,000 in cash and \$10,000 of employer-paid LTCI, the first employee would be taxed on \$100,000, and the second employee would be taxed on only \$90,000. In the example, the employer would not violate Code § 125(f) because no pre-tax amounts are being spent on long-term care insurance.

IRS Response: If an employer permits employees to make one-time election to receive cash or a qualified benefit, then it is a Code § 125 plan. However, long-term care is not permitted under Code § 125, so the employer cannot offer a one time election to receive long-term care in lieu of salary. If the employer is just providing long-term care then that is permissible. The Service representative believes that it is a factual question as to whether the employer is offering a choice between pay and benefits. Since Congress went out of its way to say that it did not want long-term care in a cafeteria plan, the IRS is going to more closely scrutinize these arrangements.

9. § 162(l) – Deduction of Contributions to a Health FSA

May a self-employed person deduct contributions to a health FSA that is not part of a cafeteria plan under Code § 162(l)?

Proposed Response: Yes. Code § 162(l) clearly applies to insurance arrangements even if they are self-insured, and, in the IRS's view, the presence of risk-shifting is the touchstone of insurance for this purpose. *See, e.g.*, PLR 9814023 (Dec. 23, 1997); PLR 200007025 (Nov. 19, 1999). A health FSA by definition exhibits the risk-shifting needed to be an accident and health plan under Code §§ 105-106, and therefore should qualify as insurance for purposes of Code § 162(l), as well.

IRS Response: The Service representative disagrees with the proposed response. The Service representative believes that this is like a disguised cafeteria plan and self-employed individuals are not permitted to make a Code § 125 election.

10. § 401(a) – Determination Letter Process: Off-cycle Filings

A qualified plan files off-cycle under Revenue Procedure 2005-66 and receives a favorable determination letter, subject to the adoption of certain amendments proposed to the IRS. How long does the employer have to adopt the amendments?

Proposed Response: The employer has until the later of: (1) 91 days after the date on the favorable determination letter, or (2) the end of the employer's current five-year remedial amendment cycle. See Treasury Regulation § 1.401(b)-1(e)(3); Revenue Procedure 2005-66, Section 6.02.

IRS Response: The Service representative disagrees with the proposed response. The employer has 91 days after the date of the letter to adopt the approved amendments. An employer does not have the extended remedial amendment period to adopt the amendments.

11. § 401 – Determination Letter Process: Off-cycle Filings

What is the IRS policy with respect to off-cycle filings? Will the IRS provide a list of what situations they will give priority to an off-cycle filing? Has the IRS reviewed any off-cycle submissions?

Proposed Response: The IRS will review off-cycle plans in the following circumstances: new plans, terminating plans, plans involved in mergers and acquisitions.

IRS Response: The IRS is moving toward giving some additional priorities for off-cycle filings that will be outlined in some upcoming guidance that will hopefully be issued soon. Some new plans will receive priority. Terminated plans already have priority and the IRS is trying to clarify that even further, but nothing is changing as far as terminated plans. In certain instances of extreme business need where employers really need a determination letter, the IRS will listen carefully. Examples of extreme business need include plans involved in corporate transactions, partial termination rulings and affiliated service group rulings. The IRS is expanding the rules on off-cycle filings but expansion will be limited.

12. § 401 – Deadline for Adopting Pension Protection Act Amendments

Section 1107 of the PPA provides that pension plan or contract amendments need to be made on or before the last day of the first plan year beginning on or after January 1, 2009. However, IRS Revenue Procedure 2005-66 generally requires a discretionary amendment to be adopted by the end of the plan year in which it is effective, and an interim amendment reflecting a qualification change to be adopted by the due date (including extensions) for filing the employer's income tax return. What is the deadline for adopting amendments that reflect the PPA?

Proposed Response: The amendment must be made on or before the last day of the first plan year beginning on or after January 1, 2009 (January 1, 2011 in the case of a governmental plan). See Notice 2007-3, Cumulative List of Changes in Plan Qualification Requirements. These deadlines also apply to discretionary amendments due to changes in the PPA.

IRS Response: The general rule on interim amendments is that they must be made by the tax filing deadline for the tax year in which the amendment is effective. If the amendment is purely discretionary, it needs to be made by the end of the plan year. Section 1107 of PPA gives plan sponsors until the end of the 2009 plan year (and until the end of the 2011 plan year for governmental plans) to amend for PPA.

The IRS has been saying publicly that it is leaning toward providing that discretionary amendments that are pursuant to PPA have until the end of the 2009 plan year. The IRS is going to confirm this answer in formal published guidance in the revenue procedure updating the determination letter program. Because the guidance has not been issued, this is not a final decision. The 2009 deadline is only for PPA amendments. Plan sponsors are going to have to make other discretionary amendments prior to 2009 (*e.g.*, an amendment for adding discretionary features to a 401(k)).

13. § 401 – Determination Letter Process: Amendments to Pre-Approved Plans

If an employer adopts a prototype plan and makes an amendment to adopt a choice that is not contained in the adoption agreement (*e.g.*, the amendment provides that special bonuses are not included in compensation, or that two loans will be permitted in each year), the plan is treated as an individually designed plan under Rev. Proc. 2005-66.

Question A: When is the plan required to be submitted to the IRS?

Question B: Will the plan be required to adopt any amendments other than those contained in the prototype document and provided by the prototype sponsor at the time of submission?

Proposed Response A: The deadline for the first submission cycle is the regular prototype 6-year cycle; for later submission, the due date is based on the individually designed due date.

Proposed Response B: The plan is based on a prototype document and only those amendments required for the prototype plan will be reviewed in the submission (*e.g.*, for the first cycle, based on the 2004 Cumulative List, Notice 2004-84).

IRS Response: The IRS will be issuing guidance updating Revenue Procedure 2005-66 which will have some specific rules and examples to address how this will work. The IRS wants to keep these plans under the 6-year cycle to some extent even if they are technically individually designed. For example, if a plan is a prototype and it is amended to create an individually designed plan, the IRS does not want to automatically put that plan into a 5-year remedial amendment cycle. Eventually that might happen, but initially the plan should be submitted when the other plans under the 6-year cycle are submitted. The IRS believes that the opening of the 2-year window for submissions of pre-approved defined contribution plans will be early next year. A Form 5300 generally will be required if a plan is individually designed. There also is a question of whether the plan must be restated for it to be submitted for a determination letter. This will be addressed in the upcoming guidance.

14. § 401 – Determination Letter Process: Multiple Employer Plans

Multiple employer plans are assigned by Rev. Proc. 2005-66 to Cycle B. Some companies that sponsor several similar single employer plans for employees in separate business units or on separate payrolls may find that some of their plans are technically multiple employer plans from time to time because small groups of employees who work for an employer outside the controlled group are covered by the plan, usually only temporarily. This can occur, for example, when an

operation is outsourced or a business unit is sold and the new employer does not maintain a plan and needs time to establish one. Such a multiple employer plan may have that status in one year but not in another. In determining whether to file in Cycle B, is a plan treated as a multiple employer plan if it had such status at any time during the period since it received a GUST letter or only if has such status at the time of filing? May the sponsor of one or more such plans whose EIN would normally place it in another cycle file all of its plans together in Cycle B so these similar plans will be considered together, as has always been the case in the past, without some of the plans being severed from the others and treated as off-cycle?

Proposed Response: A plan falls into Cycle B if it is a multiple employer plan at any time during the periods for which a determination letter is sought, even if it does not have that status at the time of the determination letter application. However, as a policy matter, where a plan sponsor maintains a group of plans that are primarily for its own employees, some of which are multiple employer plans and some of which are not, the sponsor may file all of its plans together in Cycle B and they will be considered together without any of the plans being treated as off-cycle. This will be more efficient for the IRS and will avoid the possible complications arising from plans falling into cycles that could be separated by several years even though they have the same sponsor, contain similar provisions and are aggregated for various purposes.

IRS Response: The IRS does not have a specific rule in the existing Revenue Procedure on the issue presented in this question nor does it intend to address this situation in its upcoming guidance on the determination letter process. The Service representative believes this is something that will need to be addressed in the future. If a plan sponsor has this situation, it should approach the IRS individually. In its upcoming guidance, the IRS is hoping to address the timing of a determination letter submission when a multiple employer plan elects into multiemployer status by filing an election with the PBGC. Under the Multiemployer Pension Plan Amendments Act of 1980, plans could irrevocably elect multiple employer status. The PPA now allows an election into multiemployer plan status, but the election must be made within one year of the date the PPA was enacted. If a plan makes this election, it may not know by the end of Cycle B whether it is a multiple employer plan or a multiemployer plan because the PBGC may not have approved the election by the end of Cycle B. The IRS is hoping to address this situation in its upcoming guidance.

15. § 401(a)(4) – Nondiscrimination Testing

A profit sharing plan provides that some groups of employees enter the plan upon date of hire, and other groups of employees enter the plan after completing one year of service. The plan passes Code § 410(b) minimum coverage testing. Is immediate eligibility also considered a “benefit, right, or feature” that must be tested under Code § 401(a)(4)?

Proposed Response: No. According to Treasury Regulation § 1.401(a)(4)-4(e)(3)(iii), “rights and features” include features available to participants already in the plan, such as the right to make or receive contributions, the right to direct investments, or the right to a plan loan. They do not include plan design elements relating to who is included in, or excluded from, the plan. The discriminatory impact, if any, of one group of employees entering the plan earlier than another group of employees will be picked up in the Code § 410(b) minimum coverage testing.

IRS Response: The Service representative agrees with the proposed response. Treasury Regulation § 1.401(a)(4)-4(e)(3)(ii) provides exceptions to what is considered a benefit, right or feature. This is not one of the exceptions specifically provided in the regulation. Nonetheless, the Service representative agrees that this is not a benefit, right or feature.

16. § 401(a)(11), § 411(d), § 417 – Elective Transfers

In the case of an elective transfer under Treas. Reg. § 1.411(d)-4 Q&A 3(b) and/or Code § 411(d)(6)(D), if a transferor plan that is not subject to Code § 412 has chosen to satisfy Code §§ 401(a)(11) and 417 by offering a QJSA and QPSA rather than by using the single-sum spousal death benefit exception, is it necessary to preserve the QJSA after transfer?

Proposed Response: No, except for any portion of the amount transferred that is ineligible for the single-sum spousal death benefit exception (*i.e.*, is attributable to a plan that is or was subject to Code § 412) and the recipient plan requires the participant to adhere to the single-sum spousal death benefit rules unless the participant obtains his spouse's consent to the contrary.

IRS Response: The Service representative agrees with the proposed response. Treasury Regulation § 1.411(d)-4 Q&A 3(b)(iii)(2) provides an example in which the transferring plan was subject to Code § 417 but the receiving plan was not. The receiving plan was still required to satisfy Code § 417. In this example, the plan is not subject to Code § 417, so by implication there is no qualification requirement that had to be met under the transferring plan because this particular plan is not subject to Code § 412 or § 417.

17. § 401(a)(35) – Diversification Rights: Investment in Employer Securities

Notice 2006-107 provides that Code § 401(a)(35)(D)(ii)(II) prohibits a plan from imposing restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan. The Notice outlines permitted and prohibited restrictions on the investment in employer securities. For example, a provision that provides that the employer securities investment fund is closed is permitted, but a restriction that prohibits a reinvestment in employer securities for a period of time after the participant elects to divest an investment in employer securities is prohibited.

Can the plan contain a provision that permits an investment in employer securities at the time of deposit but prohibit the participant from directing any amounts invested in other plan investments into employer securities (or once the participant elects to move his account out of employer stock, he cannot elect to reinvest in employer stock)?

Proposed Response: The purpose of Code § 401(a)(35) is to allow participants to move their investments out of employer stock. The statute does not have the same concerns with restricting the time and frequency of permitting investments in employer stock.

The plan can contain a restriction on reinvesting funds back into employer stock as long as they don't impose a penalty with respect to other benefits under the plan (such as the example in Notice 2006-107 of reducing the amount of the matching contribution if the funds are not invested in employer securities.)

IRS Response: The Service representative noted that the IRS has received a number of questions on this issue and they do not currently have an answer. They are working on guidance that they expect to have completed by the end of the year.

18. § 401(a)(35) – Diversification Rights: Service Requirement

PPA § 901 provided new Code § 401(a)(35) and Section 204 (j)(1) of ERISA. Under the diversification rule in Code § 401(a)(35)(C) for employer securities, individuals must have at least 3 years of service.

Question A: May a plan use a different method to measure service for this purpose than it uses for other purposes?

Question B: May this service be determined at the end of the plan year or must it be done on a continuous basis throughout each plan year resulting in the notice being provided continually and diversification beginning on any day in a plan year?

Proposed Response A: Yes.

Proposed Response B: A plan may by design elect to determine if 3 years of service have been completed and then permit the diversification to occur on the first day of the next following plan year for ease of plan administration.

IRS Response: Notice 2006-107 provides that the date on which a participant completes three years of service occurs immediately after the end of the third vesting computation period. If the plan provides for full immediate vesting or the plan uses the elapsed time method, the date on which the participant completes three years of service is the third anniversary of the date of hire.

19. § 401(a)(35) – Diversification Rights: Mid-Year Timing

For the transition rule under Code § 401(a)(35)(C), an account is determined as of December 31, 2006. If an employee completes 3 years of service after this date, must the employee immediately be permitted to diversify 1/3 of the employee's account or may the employee be required to wait to diversify until the next quarter since quarterly investment decisions are required as a minimum under Code § 401(a)(35)(D)(ii)? Alternatively, can the employee be required to wait until the first day of the next plan year?

Proposed Response: This is determined by plan design and the participant can be forced to wait until the first day of the next plan year.

IRS Response: The Service representative disagrees with the proposed response. Once a participant has three years of service, the diversification requirements are effective.

20. § 401(a)(35) – Diversification Rights: Reasonable Restrictions

Employers may impose reasonable restrictions under new Code § 401(a)(28)(D)(ii), such as diversifying out of employer stock on a quarterly basis. However, if other investments can be changed on a daily basis must the diversification out of employer securities occur daily or may it remain on a quarterly basis?

Proposed Response: Diversification out of the employer securities must be permitted on a daily basis since participants may change other investments daily.

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

21. § 401(a)(35) – Diversification Rights

May the reasonable restrictions not only consider periods in which the federal securities laws mandate that trading ceases, but also those periods in which an employer imposes cessation in trading to facilitate compliance with Rule 10b-5 and 16(b)?

Proposed Response: Yes, the blackout trading rules issued by the U.S. Department of Labor and the Securities Exchange Commission contemplate only cessations where the securities law mandates cessation in trading which are far fewer than those times during which most publicly traded companies impose trading cessations in order to prevent Rule 10b-5 and Section 16(b) or other similar violations. When the compliance initiatives required by the Sarbanes-Oxley Act are considered, the latter approach used by many companies to avoid or prevent potential violations is the more prudent approach.

IRS Response: Notice 2006-107 provides that an employer may impose reasonable restrictions that are designed to comply with securities laws. Employers are not required to impose the smallest restriction, rather there is some flexibility but the restrictions must be reasonably designed to comply with securities laws and cannot be way overbroad.

22. § 401(a)(35) – Diversification Rights: Interaction of Transition Rules and § 404(a)(6)

How do the new rules apply to employer contributions of stock made in 2007, attributable to 2006 payroll? Are they deemed to be in the account on December 31 if they are contributed by the extended due date as provided in Code § 404(a)(6) or are the employer contributions invested in employer stock determined by what is actually physically in the account as of December 31, 2006?

Proposed Response: Code § 404(a)(6) treats such contributions as contributed on the last day of the plan year and thus are not treated as contributions in 2007 subject to the new rules.

IRS Response: The Service representative agrees with the proposed response. The diversification rules are based on when the stock is allocated to a participant's account. In this case, the stock was allocated as of December 31, 2006, even though it was contributed in 2007. As a result, it is subject to the transition rule and not the ongoing rule.

23. § 401(a)(35) – Diversification Rights: Application to ESOPs

Does Code § 401(a)(35) apply to employer plans with an employer stock fund that is an investment option, but that does not designate the employer stock fund as the ESOP portion of the plan?

Proposed Response: Yes.

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

24. § 401(a)(35) – Diversification Rights: Application to ESOPs

New Code § 401(a)(35)(E) provides an exception for ESOPs that are separate plans for purposes of Code § 414(l) and do not contain any contributions subject to Code § 401(k) or (m).

Question A: Can an ESOP that is part of an existing plan be spun off in order to satisfy this requirement?

Question B: When must such a separation be completed in order for the plan to avoid new Code § 401(a)(35)?

Proposed Response A: Yes.

Proposed Response B: Code § 401(a)(35) will not apply once the ESOP portion of the plan is segregated into a separate plan.

IRS Response: The Service representative agrees that the ESOP portion may be spun off. The Service representative cautions that when spinning the ESOP portion of the plan off, plan sponsors must be careful to ensure that the plan continues to meet all of the ESOP rules after the spin-off and that no 401(k) or (m) money is spun off. Once the ESOP is spun off, prospectively it will not be required to satisfy Code § 401(a)(35).

25. § 401(a)(35) – Diversification Rights

Does Code § 401(a)(35) apply to a defined contribution plan that invests in employer securities, but does not offer participant directed investments?

Proposed Response: No.

IRS Response: The Service representative disagrees with the proposed response. The Service representative believes that if a plan invests in employer stock, it is subject to Code § 401(a)(35) and participants must be allowed to diversify even if the plan does not otherwise offer participant directed investments. One exception is that certain investment options will not be looked through to determine if the plan invests in employer stock. For example, if the plan sponsor is an S&P employer and the plan invests in an S&P index fund, the plan will not be treated as investing in employer stock. The IRS has received a lot of comments that this exception is too narrow. The IRS might consider loosening up this exception in the future.

26. § 401(a)(35) – Diversification Rights: Employers with Little or No Publicly Traded Stock or Thinly Traded Employer Stock

Under new Code § 401(a)(35)(F) the diversification rules can apply in situations where the stock itself is either not publicly traded or is only thinly traded. It can apply even in situations where the employer has only a small amount of other publicly traded stock, or has no other publicly traded stock at all, but only publicly traded debt. In such cases significant amounts of stock held by the plan simply cannot be disposed of quickly enough to satisfy possible diversification requests. In such cases a sudden influx of stock offered for sale may cause a sudden drop in price and raise fiduciary issues. Will any exception be provided for thinly traded stock, such as stock traded only OTC or on pink slips?

Proposed Response: An exception should be provided so that a fiduciary is not forced to liquidate stock and drive the market price down to comply with the tax requirements or to be torn between the tax requirements and the ERISA fiduciary duties. Treasury has the authority to limit the scope of Code § 401(a)(35)(F). Where the securities are thinly traded, the sudden imposition of diversification could cause a major market shift downward by flooding the market with supply when no additional demand exists and this could be potentially harmful to participants' retirement savings.

IRS Response: The IRS will take this as a recommendation and will treat this as a comment.

27. § 401(a)(35) – Diversification Rights: Violation of Company Charter Provisions

The diversification rules will in some cases violate company charter provisions prohibiting stockholders from disposing of their shares. Will any relief be provided for plans in such cases?

Proposed Response: Where a legal restriction prevents the plan from selling the shares, the diversification requirement will not be enforced.

IRS Response: There is a question as to whether these shares fall within the definition of readily tradable, which has not yet been established. If the shares are not readily tradable, it might fit within the statutory exception.

28. § 401(a)(35) – Diversification Rights: Thinly Traded Stock

“Publicly traded employer securities” is defined as “employer securities which are readily tradable on an established securities market.” What does “readily tradable” mean in this context? What about securities that are only thinly traded or not traded on a major exchange? What if it is only traded on pink slips?

Proposed Response: Publicly traded employer securities shall not include stock traded only on pink slips or that is not traded on a major exchange such as the NYSE, NASDAQ, or Amex.

IRS Response: The IRS hopes to issue guidance on this issue.

29. § 401(k), § 415 – Excess Annual Additions and the Contingent Benefit Rule

Employer maintains a 401(k) plan that provides for pre-tax 401(k) contributions, employee after-tax contributions, a fixed matching contribution made after each payroll period, and a discretionary employer profit sharing contribution made after the end of the plan year. The limitation year is the plan year. If a participant’s 401(k), after-tax, and fixed matching contributions equal the 415 dollar limitation by the end of the year, can the discretionary profit sharing contribution that would otherwise be contributed to the plan for the participant be paid directly to the participant in cash? Would it make a difference if the discretionary profit sharing contribution were an additional discretionary matching contribution?

Proposed Response: No, payment of the otherwise allocable profit sharing contribution to the participant in cash would violate the contingent benefit rule under Treas. Reg. § 1.401(k)-1(e)(6) to the extent of the employee’s elective deferrals to the plan. That is, the cash payment would not have been made if contributions allocable to the employee (including the employee’s elective deferrals) had not reached the 415 dollar limit (the profit sharing contributions would have been made to the plan instead). The contingent benefit plan exception for excess benefit and nonqualified plans under Treas. Reg. § 1.401(k)-1(e)(6)(iii) does not apply because the cash payment is not a nonqualified plan of deferred compensation or an excess benefit plan under § 3(36) of ERISA. The answer is the same for a cash payment in lieu of an additional discretionary matching contribution because the cash payment would not constitute a matching contribution under Treas. Reg. § 1.401(k)-1(e)(6)(i)(A).

IRS Response: The Service representative agrees with the proposed response. The IRS takes an expansive view of whether a benefit is contingent. In this case, the benefit would be contingent, so this arrangement is not permitted.

30. § 401(k) – Profit Sharing Contributions Treated as Qualified Non-Elective Contributions

The employer maintains a profit sharing plan, to which it has contributed 6% of pay for many years. It would now like to introduce matching contributions equal to 50% of elective deferrals not in excess of 6% of pay. Employees will have to make elective deferrals of 6% of pay in order to continue to receive the full 6% from the employer. However, it wants to continue to make profit sharing contributions at the historical 6% level for most of the NCEs, generally the lowest paid, in lieu of matching contributions. Half of the profit sharing contribution for this group (3% of pay) will meet the requirements for QNEC. Is this permissible?

Proposed Response: Yes, because even though most NHCEs will not be offered matching contributions, they will receive profit sharing contributions equal to 6% of pay. For purposes of Treasury Regs. §§ 1.401(k)-2(a)(3)(i) and 1.401(k)-2(a)(6), half of the profit sharing contribution should be considered a QNEC.

IRS Response: The Service representative disagrees with the proposed response. While QNECs are allowed to supplement the utilization of, or the lack of utilization on the part of non-highly compensated employees in an ACP test, the matching contribution must be made available to the non-highly compensated employees and then the non-highly compensated employees must not use the matching contributions before QNECs may be used to satisfy the ACP test. There is an underlying Code § 410(b) requirement with respect to the matching arrangement. Under the fact pattern, if non-highly compensated employees are not eligible for matching contributions, then no matter what non-elective contributions are made on the non-highly compensated employees behalf, the arrangement will not satisfy Code § 410(b).

31. § 401(k), § 403(b), § 409A, § 457(b) – Hardship Distributions

In Notice 2007-7, Q&A 5, Answer 5(a) states that “a primary beneficiary under the plan” is an individual who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the participant’s account balance under the plan upon the death of the participant.” Does such a “primary beneficiary” need to be explicitly and affirmatively named by a participant through a beneficiary designation form, or would determination of the participant’s beneficiary through application of plan terms suffice?

Proposed Response: The application of plan terms should suffice.

IRS Response: If the plan is drafted clearly, the plans terms can suffice. The language in Notice 2007-7 provides that the beneficiary is the individual “who is named as a beneficiary” under the plan. Notice 2007-7 could be read to require a participant to explicitly name a beneficiary. However, if the plan is clearly drafted, it could name a beneficiary for the participant. If the participant does not want to follow the plan’s default provision, then the participant could name a different beneficiary.

32. § 401(k), § 403(b), § 457(b), § 409A – Hardship Withdrawals and Unforeseeable Emergencies

Is there any restriction on how frequently a beneficiary may be changed?

Proposed Response: The plan may restrict the number of beneficiaries in a plan year.

IRS Response: There is no restriction on how frequently a beneficiary may be changed. The plan likely can establish parameters around how frequently a beneficiary may be changed. Code § 401(a)(11)(d) authorizes a plan to not provide benefits to a newly married participant who dies if the couple was married less than one year. In that spirit, a plan might limit the number of times a beneficiary may be changed in one year. However, limiting the frequency of beneficiary changes could result in a violation of Code § 411(d)(6).

33. § 401(k), § 403(b), § 457(b), § 409A – Hardship Withdrawals and Unforeseeable Emergencies

Can the unforeseeable emergency or hardship occur for multiple different beneficiaries in the same year?

Proposed Response: Yes, if the designated beneficiary is changed by the participant or if there are multiple designated beneficiaries.

IRS Response: Yes, multiple beneficiaries are permissible as long as the beneficiary was named as the beneficiary at the time of the hardship. For example, if Beneficiary A is the beneficiary for the first half of the year and Beneficiary B is the beneficiary for the second half of the year, if Beneficiary B has a hardship in February, the participant may not take a hardship withdrawal for Beneficiary B's expense since Beneficiary B was not the beneficiary at the point of the hardship. Conversely, if a hardship arises for Beneficiary A in February and a hardship arises for Beneficiary B in September, then the participant may take a hardship distribution for both events since they were both beneficiaries at the time of the prospective hardships. Likewise, if a participant has named more than one beneficiary at the same time, each beneficiary is eligible for a hardship distribution. The Service representative cautions that the distribution must be for the actual hardship expense of the beneficiary and not just an excuse for a participant to receive a distribution.

34. § 401(k)(2)(B)(i) – Hardship Distributions

The hardship distribution rules in Treas. Reg. § 1.401(k)-1(d)(3)(B) provide a safe harbor under which distributions are deemed to be on account of an immediate and heavy financial need of the employee if such distributions are for certain specified purposes (*e.g.*, payment of costs related to the purchase of the employee's principal residence and payment for funeral expenses for the employee's parent, child or dependent). A 401(k) plan contains the hardship distribution safe harbor provisions and allows employees who want to receive a hardship distribution to fill out a form that includes a list of the events that constitute immediate and heavy financial needs under the safe harbor provisions. In order to be entitled to a hardship distribution, the employee only has to check a box next to the applicable event listed on the form; no substantiation of the actual existence of the event is required. Does this procedure, in the absence of any additional substantiation, satisfy the safe harbor requirements in Treas. Reg. § 1.401(k)-1(d)(3)(B)?

Proposed Response: No. The plan administrator cannot just rely on a "check the box" approach for purposes of the hardship distribution safe harbor. The plan administrator should require some additional substantiation of financial need, such as a bill, an invoice for funeral expenses, a notice of foreclosure, a contract for the purchase of a residency, or the like.

IRS Response: The Service representative agrees with the proposed response. Plan administrators are required to obtain substantiation of a hardship from the participant. Additionally, the Katrina Emergency Tax Relief Act (KETRA) provides that an employer may rely on reasonable representations from the participant for qualified Hurricane Katrina distributions. The Service

representative cautions that it may not be a reasonable representation for an employee to just check a box under KETRA, although this is not clearly stated in the guidance.

35. § 401(k)(3)(A) – Aggregation for HCEs

A not-for-profit employer sponsors a 403(b) plan for employees of the not-for-profit employer and a 401(k) plan for employees of its for-profit subsidiary. Both the 403(b) plan and the 401(k) plan use the same plan year. Assume that an employee who participated in the 403(b) plan during the plan year moves to employment with the for-profit subsidiary and participates in the 401(k) plan during the same plan year. If that employee is determined to be an HCE of the for-profit subsidiary for the plan year, are the § 403(b) elective deferrals aggregated with the § 401(k) elective deferrals when performing the ADP test?

Proposed Response: No. Treas. Reg. § 1.401(k)-2(a)(3)(ii) provides that the only cash or deferred arrangements taken into account under the ADP calculation rule for HCEs are cash or deferred arrangements that are subject to the ADP test. Further, although there is not a direct regulatory link under Treas. Reg. § 1.401(k)-1(b)(4), in general, the aggregation rules of Treas. Reg. § 1.410(b)-7 are applied, and under Treas. Reg. § 1.410(b)-7(f) plans subject to § 403(b)(12)(A)(i) are disregarded.

IRS Response: The Service representative agrees with the proposed response. The Service representative is not willing to confirm every step in the analysis, however, the Service representative agrees with the result of the answer. In performing the ADP test, only the aggregate cash or deferred arrangements of the same employer are considered. The 403(b) plan does not fall into that cash or deferred arrangement category.

36. § 401(k)(13) – Automatic Enrollment: Immediate Entry

How does an employer provide notice for plans with immediate entry? Is it sufficient to provide information on the first day of employment?

Proposed Response: The first day of employment is sufficient.

IRS Response: The IRS will treat this as a comment. The Service representative advises that to the extent language in the Code § 401(k)(13) safe harbor is identical to the Code § 401(k)(12) safe harbor, the IRS' interpretations under Code § 401(k)(12) safe harbor are likely to carry over in guidance under Code § 401(k)(13). This notice is one place where the timing rules are identical in the statute.

37. § 401(k)(13) – Automatic Enrollment: Notice Requirements

If notice is required prior to the beginning of the plan year, will it need to be provided again for participants who are eligible 90 days or more after the beginning of the plan year?

Proposed Response: When it is provided when first applicable to the participant, that is sufficient.

IRS Response: The IRS will treat this as a comment.

38. § 401(k)(13) – Automatic Enrollment: Qualified Automatic Contribution Arrangements

How long is the 3% deferral period for the first year of a Qualified Automatic Contribution Arrangement (QACA)? We read this section to mean that a new participant entering the plan after the first day of a plan year may have the 3% deferral period apply for the remainder of his entry year and all of the next plan year. Is this what is intended?

Proposed Response: Yes, the switch to the next automatic contribution rate may occur for all participants at the end of the plan year following their completion of their first year of participation, and thereafter at the end of each succeeding plan year.

IRS Response: The IRS will treat this as a comment.

39. § 401(k)(13) – Automatic Enrollment

An employer that sponsors a Code § 401(k) plan with an automatic enrollment feature decides to introduce an automatic increase feature for non-highly compensated employees. Employees may opt out of the automatic increase feature at any time. If an employee does not opt out, his or her contribution percentage would increase annually unless, within a designated period before the automatic increase would take effect, the employee elects to stop elective deferrals or to contribute a different percentage of compensation. Automatic increases for a particular employee would take effect on the anniversaries of his or her hire date. Thirty days before implementing the automatic increase feature, the employer provides to existing participants an initial notice describing (a) the participant's right to opt out of the automatic increase feature and the procedure for doing so, (b) the timing and amount of scheduled increases and the right to elect a different contribution percentage (or to make no contributions), and (c) the procedure for electing a different contribution percentage and the time by which an election must be made to avoid the automatic increase. The initial notice (together with the plan's notice regarding automatic enrollment) also is provided to employees hired after implementation of the automatic increase feature thirty days before automatic enrollment for the employee would take effect. Finally, the above information is provided to participants annually, as part of the notice required for ERISA preemption described in Section 902(f) of the PPA, thirty days before the beginning of each plan year. Notice of the automatic increases is not provided at any other time during the plan year.

Question A: Is this sufficient notice to participants of the automatic increases?

Question B: Under the facts of Question A, would limiting the automatic increase feature to non-highly compensated employees result in a discriminatory "benefit, right or feature" under Code § 401(a)(4)?

Proposed Response A: Yes. The Department of the Treasury's General Information Letter to J. Mark Iwry (dated 3/17/04) and Revenue Ruling 2000-8, 2000-1 C.B. 617 (1/17/00) indicate that automatic increases are permissible in a 401(k) plan provided an initial and annual notice, such as the notices described above, are provided. It is not necessary that a participant also receive a notice within a reasonable period before an automatic increase will take effect. For example, a participant who is scheduled to have an automatic increase take effect on September 30th need not receive a notice describing the above information within a reasonable period before September 30th.

Proposed Response B: No.

IRS Response: The IRS will treat this as a comment.

40. § 401(m)(2)(B) – Aggregation for HCEs

A not-for-profit employer sponsors a 403(b) plan for employees of the not-for-profit employer and a 401(k) plan for employees of its for-profit subsidiary. Both the 403(b) plan and the 401(k) plan have an employer matching feature and both plans use the same plan year. Assume that an employee who participated in the 403(b) plan and received employer matching contributions under the 403(b) plan during the plan year moves to employment with the for-profit subsidiary and participates in the 401(k) plan during the same plan year and receives employer matching contributions under the 401(k) plan. If that employee is determined to be an HCE of the for-profit subsidiary for the plan year, are the Section 401(m) employer matching contributions to the 403(b) plan aggregated with the § 401(m) employer matching contributions to the 401(k) plan when performing the ACP test?

Proposed Response: No. Although there is not a direct regulatory link under Treas. Reg. § 1.401(m)-1(b)(4)(iii)(B), in general, the aggregation rules of Treas. Reg. § 1.410(b)-7 are applied, and under Treas. Reg. § 1.410(b)-7(f) plans subject to § 403(b)(12)(A)(i) are disregarded. In addition, as discussed in question 35 above, the § 401(k) regulations provide that § 403(b) elective deferrals are not aggregated with § 401(k) elective deferrals when performing the ADP test. From a policy perspective, it makes no sense to apply a different HCE contribution aggregation rule for purposes of performing the ACP test than is used for ADP testing.

IRS Response: The Service representative is unsure about this response and cautions the plan sponsor to carefully review Treas. Reg. § 1.410(b)-7(f) and Treas. Reg. § 1.401(m)-2. Treas. Reg. § 1.410(b)-7(f) clearly provides that in determining whether a plan satisfies Code § 410(b), a plan subject to Code § 403(b)(12)(A)(i) is disregarded. In other words, when performing the 401(k) ACP test, the 403(b) plan is disregarded. When aggregating for purposes of highly compensated employee contributions, plans do not aggregate to the extent they are not permitted to aggregate under Code § 410(b). In determining whether a plan subject to Code § 403(b)(12)(A)(i) satisfies Code § 410(b), plans not subject to 403(b) may be taken into account. In other words, there may be two different results. When performing the qualified plan ACP test, the 403(b) plan is not taken into account. When performing the 403(b) version of the ACP test, the 401(a) plan match is taken into account.

41. § 402(c)(11) – Distributions to Inherited IRA of Non-Spouse Beneficiary

Facts: A qualified plan is amended to provide that a non-spousal beneficiary may transfer his/her account to an inherited IRA via a direct rollover as provided for in § 402(c)(11) and IRS Notice 2007-7. Notice 2007-7 Q&A-11 references Treas. Reg. § 1.401(a)(31)-1, Q&A 3 and 4 for procedures for making the direct rollover. The qualified plan calculates any required minimum distribution amount in the year of distribution in order to determine the amount which is eligible for rollover, but does not communicate any further information concerning the minimum required distribution provisions of the qualified plan to the non-spousal beneficiary or to the inherited IRA receiving the direct rollover. The qualified plan will issue the Form 1099-Rs that are required.

Question A: Does the qualified plan have an affirmative duty to ensure that the IRA to which a 402(c)(11) direct rollover is being made is classified as an inherited IRA?

Question B: Besides making the payment to the IRA consistent with the procedures in Treas. Reg. § 1.401(a)(31)-1, Q&A 3 and 4 (after satisfying any minimum required distribution required for

such year) and issuing the required Form 1099-Rs, does the qualified plan from which the direct rollover is being made have any other responsibilities advise the IRA regarding the minimum required distribution provisions that applied to the account prior to distribution?

Proposed Response A: No. Apart from making the payment to the IRA consistent with the procedures in Treas. Reg. § 1.401(a)(31)-1, Q&A 3 and 4 (after satisfying any minimum required distribution required for such year), and issuing the required Form 1099-Rs, the qualified plan from which the direct rollover is being made has no other responsibilities to effectuate the direct rollover. The qualified plan has no duty to determine whether the non-spousal surviving beneficiary has identified an IRA that qualifies as an inherited IRA. That is the beneficiary's responsibility alone.

Proposed Response B: No. Apart from making the payment to the IRA consistent with the procedures in Treas. Reg. § 1.401(a)(31)-1, Q&A 3 and 4 (after satisfying any minimum required distribution required for such year) and issuing the required Form 1099-Rs, the qualified plan from which the direct rollover is being made has no other responsibilities to effectuate the direct rollover. The qualified plan has no duty to communicate the specific minimum required distribution provisions that apply to the qualified plan to either the non-spousal beneficiary or the inherited IRA receiving the direct rollover.

IRS Response: Nothing explicitly provides that the qualified plan must ensure that the rollover is classified as an inherited IRA. However, the qualified plan must report the distribution on a Form 1099-R. If the qualified plan does not know whether the amount was rolled to an inherited IRA, there will be a question of whether the rollover was taxable or whether it was excludable as a rollover contribution. The Service representative also commented that if a beneficiary asks for assistance, it is likely not sufficient to tell the beneficiary that he is on his own. On the other hand, there is not a specific rule that the qualified plan is required to report the required minimum distribution to a beneficiary like it would for an employee. The Service representative does not believe there is any greater duty for this type of rollover than for a regular employee rollover.

42. § 402(c)(11), § 408(d)(8) – Rollovers to Non-Spouse Designated Beneficiaries

Questions are arising regarding the effective date and application of the rollover provisions for a deceased participant to non-spousal designated beneficiaries under PPA § 829 amending Code § 408(d)(8) and Code § 402(c)(11). This applies to distributions after December 31, 2006. Is there any limit on the number of non-spouse designated beneficiaries to which an account can be rolled over (*e.g.*, if there are 10 designated co-beneficiaries)?

Proposed Response: No.

IRS Response: The individuals who are the designated beneficiaries are the individuals who can rollover the account. In order to be eligible for a direct rollover, the individual must be a designated beneficiary. The rollover provisions are effective for distributions on or after January 1, 2007. The rollover must be for the amount that is eligible for rollover versus the amount that is a required minimum distribution and not eligible for rollover.

43. § 402(c)(11), § 408(d)(8) – Rollovers to Non-Spouse Designated Beneficiaries

Are there any limits as to who can be a designated beneficiary or how many designated beneficiaries a participant may have? Additionally, do contingent beneficiaries count as designated beneficiaries?

Proposed Response: No.

IRS Response: The Service representative believes it is a question of whether the individual is a designated beneficiary. The Service representative indicated that this question has arisen before and that they may need to think more about this issue.

44. § 402(c)(11),§ 408(d)(8) – Rollovers to Non-Spouse Designated Beneficiaries: Plan Defined Restrictions on Rollovers

What obligations will plans have to accept rollovers of inherited IRAs for designated beneficiaries?

Proposed Response: None.

IRS Response: A direct rollover will be to an IRA, but that IRA could be part of a plan as a deemed IRA. Otherwise, a 401(a) plan without a deemed IRA is not permitted to accept rollovers of inherited IRAs.

45. § 402A(d)(2)(B) – First Taxable Year for Which a Roth Elective Deferral is Made

An employer sponsors two 403(b) plans that would be considered separate plans under § 414(1). If an employee makes Roth elective deferrals to one of the plans in 2006 and no further contributions to that plan, and then makes Roth elective deferrals to the other plan in 2007, is the 5-taxable-year period for the employee determined separately for each of the 403(b) plans?

Proposed Response: Yes. Treas. Reg. § 1.402A-1, Q&A 4 provides that the 5-taxable-year period determination is made separately for each plan that is considered to be a separate plan under § 414(1).

IRS Response: The Service representative agrees with the proposed response. The cite to Treas. Reg. § 1.402A-1, Q&A 4 is directly on point.

46. § 402(f) – Rollovers of After-Tax Contributions

The IRS 402(f) notice describes the following rules for rollovers of after-tax contributions in annuity contracts: “You can also roll over after-tax contributions from a section 403(b) tax-sheltered annuity to another section 403(b) tax-sheltered annuity using a direct rollover if the other tax-sheltered annuity provides separate accounting for amounts rolled over, including separate accounting for the after-tax employee contributions and earnings on those contributions.” Section 822 of the Pension Protection Act, “Allow Rollover of After-Tax Amounts in Annuity Contracts,” amended Internal Revenue Code Section 402(c)(2) to permit a direct rollover of after-tax contributions to a § 401(a) qualified plan or to a § 403(b) annuity contract, provided the plan or contract provides for separate accounting. Can after-tax contributions now be rolled over from a § 403(b) annuity contract to a § 401(a) qualified plan using a direct rollover?

Proposed Response: Yes. The IRS 402(f) notice will be modified accordingly.

IRS Response: The IRS is considering modifying the Code § 402(f) notice not only for this issue but for other issues as well. The Service representative is hoping that updating the model Code § 402(f) notice will be on the guidance plan for next year.

47. § 403(b), § 457(f) – Salary Reduction Contributions from 457(f) Plan

An employer sponsors a Code § 457(f) plan that provides for vesting and immediate payout upon a fixed date. The employee also participates in the employer’s Code § 403(b) plan. The employee is still employed on the payout date. Can the employee make salary reduction contributions into the 403(b) plan from the 457(f) plan distribution?

Proposed Response: Yes. The 457(f) plan distribution will be reported in Box 1 of the W-2. The employee’s 403(b) plan contribution election will reduce Box 1 wages. No provision of Code § 457(f), Code § 403(b) or Code § 409A prohibits a salary reduction contribution from amounts that would otherwise be includible in wages upon distribution from a 457(f) plan.

IRS Response: Amounts distributed from a Code § 457(f) plan are treated as wages and are includible compensation for purposes of Code § 403(b). The salary deferral going into the Code § 403(b) plan does not change anything with respect to that inclusion in income. The amounts coming out of the Code § 457(f) plan are taxable and must be included in income in the year the amounts are no longer subject to a substantial risk of forfeiture. The salary deferral into the Code § 403(b) plan does not matter here. The Code § 457(f) plan distribution is reported in Box 1 of the Form W-2, but the § 403(b) election to take a salary deferral on that same money would not reduce Box 1 on the Form W-2 accordingly.

48. § 403(b)(5) – Definition of “Plan” for Purposes of Retirement Plan Nondiscrimination Testing

An employer maintains two 403(b) arrangements with two separate vendors. Each arrangement has its own plan document, and employees can choose to participate in either arrangement. Employees can switch back and forth between the two 403(b) arrangements, but cannot participate in both at the same time. The provisions of each arrangement are identical in all respects; each has a separate trust and assets of one trust cannot be used to pay benefits due under the other trust.

May the two arrangements be treated as separate plans for purpose of nondiscrimination testing so that each plan is permitted satisfy the provisions of § 403(b)(12)(A)(i) separately?

Proposed Response: Yes, while § 403(b)(5) provides that all 403(b) annuity contracts purchased by the employer are treated as one contract, § 403(b)(12)(A)(i) provides that, with respect to contributions other than salary reduction contributions, the 403(b) plan is treated as if “such plan were described in section 401(a).” In testing 401(a) plans, the relevant sections (§§ 401(a)(4), 410(b), etc.) define “the plan” for purposes of testing as a plan described in § 414(l) (*see, e.g.*, Treas. Reg. § 1.410(b)-7(a)). Treas. Reg. § 1.414(l)-1(b)(1) provides that “more than one plan will exist if a portion of the plan assets is not available to pay benefits under the other plan.” In the example described above, since the assets of one trust cannot be used to pay benefits under the other trust, the plans are treated as two plans for purpose of nondiscrimination testing.

IRS Response: The Service representative generally agrees with the proposed response but cautions that the employer must look at whether elective deferrals are involved. If elective deferrals are involved, there is a universal availability issue. The Service representative also pointed out that two plans require two filings of the Form 5500.

49. § 404(a)(7)(C) – Limitations on Deductions for Combinations of Defined Contribution and Defined Benefit Plans

The PPA amended Code § 404(a)(7)(C), relating to limitations on deductions for combinations of defined contribution and defined benefit plans. In the case of employer contributions to one or more defined contribution plans, § 404(a)(7) now only applies “to the extent that such contributions exceed 6 percent of the compensation otherwise paid or accrued.” Assume that an employer’s deductible defined benefit contribution is 20%. What is the maximum deductible contribution that the employer can make to the defined contribution plan?

Proposed Response: The employer can make a deductible contribution to the defined contribution plan of 11% of the compensation otherwise paid or accrued. Code § 404(a)(7)(A)(i) limits the total amount deductible in connection with the defined contribution and defined benefit plans to 25% of the compensation otherwise paid or accrued. Under new Code § 404(a)(7)(C)(iii), § 404(a)(7) only applies to the extent that the defined contribution plan contributions exceed 6% of compensation. Therefore, for an 11% defined contribution plan contribution, only 5% is taken into account under § 404(a)(7)(A)(i). The 5% defined contribution plan contribution plus the 20% defined benefit plan contribution meet the 25% deductible limit under § 404(a)(7)(A)(i).

IRS Response: The Service representative agrees with the proposed response. In this fact pattern, the employer may make a deductible contribution of 11% to the defined contribution plan in addition to the 20% contribution to the defined benefit plan because the first 6% is disregarded. Code § 404(a)(7) applies in this fact pattern because the contributions going into the defined contribution plan are greater than zero.

50. § 404(a)(7)(C) – Limitations on Deductions for Combinations of Defined Contribution and Defined Benefit Plans

For years beginning in 2008, the PPA further amended Code § 404(a)(7)(C). In applying the limitations on deductions for combinations of defined contribution and defined benefit plans, a defined benefit plan which is a single-employer plan covered under ERISA § 4021 will be disregarded. A partnership sponsors a defined benefit plan, which covers only partners and professional corporations which are partners. The plan does not meet any of the exceptions under ERISA § 4021(b), such as a professional service employer’s plan with no more than 25 active participants. Is this plan a “single-employer plan” that will be disregarded?

Proposed Response: Yes. ERISA § 4001(a)(15) defines “single-employer plan” as a defined benefit plan (as defined in ERISA § 3(35) which is not a multiemployer plan. ERISA § 4001(a)(3) defines “multiemployer plan” as a collectively bargained plan to which more than one employer is required to contribute. Because the plan is not collectively bargained, it must be a “single-employer plan.”

IRS Response: Notice 2007-28 did not address this question. The Notice only dealt with the 2006 and 2007 years. This law becomes effective in 2008. The question is whether the partnership is a single employer, which is the requirement to receive this exemption under ERISA. The Service representative disagrees that the partnership would be a single employer plan in this example. If this example is referring to corporations only having 100% owners, then the Service representative believes that the entire plan is exempt from ERISA. If the entire plan is exempt from ERISA, then Title IV does not come into play. In other words, the ability to ignore the plan requires the plan to be covered by ERISA § 4021. If it is not covered by ERISA at all, then it is not covered by ERISA § 4021.

51. § 404(a)(12) – Profit Sharing Contributions

The only employee of a corporation earns \$100,000 and makes elective deferrals of \$15,000 into the corporation's 401(k) plan. The corporation wishes to make the maximum profit sharing contribution of 25% of compensation on behalf of the employee. Is the maximum profit sharing contribution 25% of \$100,000, or 25% of \$85,000?

Proposed Response: The maximum profit sharing contribution is 25% of \$100,000. Code § 404(a)(12) provides that, for purposes of the limits on deductible contributions to profit-sharing trusts, "compensation" includes elective deferrals under Code § 415(c)(3)(D).

IRS Response: The Service representative agrees with the proposed response. The maximum deduction is 25% of \$100,000.

52. § 408(d)(8) – IRA Rollovers to Charities

The statutory provision is effective January 1, 2006 and individuals are currently interested in making qualified charitable distributions. Will good faith compliance after the date of enactment be sufficient to meet the statute's requirement until guidance is issued?

Proposed Response: Yes.

IRS Response: The IRS issued guidance on this issue in Notice 2007-7.

53. § 411 – Change in Vesting Schedule

Q-28 of Notice 2007-7 provides that a change in a vesting schedule to satisfy Code § 411(a)(2)(B) must satisfy Code § 411(a)(10). It is very common for defined contribution plans to have different vesting schedules for employer nonelective contributions and matching contributions. Many plans are primarily intended to provide benefits in the form of elective contributions and matching contributions, and in a significant number of these plans no nonelective contributions have ever been made. No nonelective contributions would have been made in these plans either because the plan does not provide for employer nonelective contributions (other than if a top-heavy contributions under Code § 416(c) are required) or the plan provides for employer discretionary nonelective contributions but no such contributions have been made for plan years beginning before January 1, 2007. Does a defined contribution plan that has never had any nonelective contributions made for plan years beginning before January 1, 2007, need to comply with Code § 411(a)(10) when amending the vesting schedule for employer nonelective contributions to comply with Code § 411(a)(2)(B)?

Proposed Response: No. In a plan in which no nonelective employer contributions have ever been made, Code § 411(a)(10)(A) does not apply because there is no existing accrued benefit to which such provision could apply. Code § 411(a)(10)(B), which requires participants with at least three years of service be eligible to elect to determine their nonforfeitable percentage without regard to the amended schedule, does not apply because if no nonelective contributions have ever been made, no individual would have had three years of service with respect to the nonelective contribution portion of the plan. Similarly, if a plan that previously provided for only nonelective contributions is amended to include matching contributions, any vesting schedule that complies with Code § 411(a)(12) may be adopted for the matching contributions that will be made subsequent to the amendment without a requirement that such vesting schedule comply with Code § 411(a)(10).

IRS Response: When a plan sponsor changes a vesting schedule, it must comply with three rules. The first rule is that a participant's current vesting percentage is never reduced. If, for example, a participant was 40% vested, no change in the vesting schedule will ever make the participant less than 40% vested. The second rule is the election rule with respect to participants who have three years of service. If a participant has three years of service, the participant must be given the opportunity to elect which vesting schedule he or she wants and that schedule applies to both accrued benefits and future accruals. The third rule has come out of the post-Heinz Code § 411(d)(6) regulations which provide that a participant has a Code § 411(d)(6) right to grow into vesting with respect to the participant's accrued benefit as of the date of the amendment.

54. § 411(a)(10) – Change in Vesting Schedule Due to Plan Merger

Question A: If a plan with full and immediate vesting (the "Merged Plan") is merged into a plan with three-year cliff vesting (the "New Plan") are the requirements of Code § 411(a) and Treas. Reg. § 1.411(a)-8 satisfied with respect to employees with less than three years of service who participated in the Merged Plan, if the benefits of such employees (i) accrued under the Merged Plan are fully vested as of the date of merger and (ii) accrued under the New Plan, are subject to the vesting schedule of the New Plan?

Question B: If the Proposed Response in (a) is correct, then doesn't Treas. Reg. § 1.411(a)-8(a) trump Code § 411(a)(10)(B) and Treas. Reg. § 1.411 (a)-8T in almost all cases?

Proposed Response A: No, pursuant to Treas. Reg. 1.411(a)-8(a), if a vesting schedule is amended, the participant's nonforfeitable percentage as of the later of the effective date or adoption date may not be reduced. Thus, a participant in the Merged Plan must always be 100% vested in all benefits under the New Plan (including those accrued after the effective date of the merger).

Proposed Response B: Yes.

IRS Response: Even if there are no accrued benefits under a plan, if the vesting percentage was 100%, it must stay at 100% for all future benefit accruals.

55. § 411(d)(6) – Protected Benefits

An employer sponsors two defined contribution plans qualified under Code § 401(a) (Plan X and Plan Y). Each qualified plan allows a participant that has separated from service to elect to receive fixed distributions from the plan. The participant is able to select the amount of the fixed distribution and the frequency (annual, semi-annual, quarterly, or monthly) of payment. The fixed distribution election can be subsequently revoked or revised by the participant at any time.

Question A: Employer and plan administrator propose to merge Plan Y into Plan X so that Plan X is the surviving plan. Plan participants will be required to make new elections regarding any fixed distributions. Fixed distributions will cease if the participant does not make a new election to receive fixed distributions from the surviving plan.

Is the right to receive fixed distributions as indicated, a protected benefit that must be preserved by the surviving plan in the above scenario?

Question B: Employer and plan administrator propose to merge Plan Y into Plan X so that Plan X is the surviving plan. Participants will not be required to resubmit a new election to receive fixed distributions. Instead, the fixed distribution election made in regards to Plan X (the surviving plan)

will control for all post-merger assets of the surviving plan (including those assets of Plan Y that were merged into Plan X).

Is an election to receive fixed distributions a protected benefit that must be preserved by the surviving plan in the above scenario?

Proposed Response A: No. A participant's right to receive fixed distributions as indicated above does not constitute a protected benefit that must be preserved, provided that Plan X as the surviving plan provides the participant with an opportunity to make a new fixed distribution election in the surviving plan.

Proposed Response B: No. A participant's right to receive fixed distributions as indicated above does not constitute a protected benefit that must be preserved, provided that the surviving plan provides the participant with an opportunity to revise or make a new fixed distribution election in the surviving plan.

IRS Response: A defined contribution plan is permitted to eliminate installment payments pursuant to Treas. Reg. § 1.411(d)(4), Q&A 2, paragraph E, if the plan preserves the identical lump sum. However, installments can only be eliminated when the annuity starting date has not begun. A plan may not eliminate installment payments if a participant has elected installment payments after the participant's annuity starting date.

56. § 7805(b) – EPCRS: VCP Compliance Fees and Submission Procedures

Plan A excludes eligible participants from making 401(k) contributions and fails to satisfy the ADP test during Year 1. During Year 2, a portion of Plan A is spun off into a new Plan B, and the spun off group includes some participants affected by the operational failures in Year 1. In Year 5, the plan administrator of Plan A discovers the operational failures and decides to correct them through a VCP submission. The proposed corrections will require corrective contributions to Plan A (some of which will be transferred to Plan B for allocation to affected participants) and corrective distributions from Plan A and Plan B. Will two VCP submissions and two compliance fees (one for Plan A and one for Plan B) be required?

Proposed Response: No, a VCP submission and compliance fee is required only for Plan A because that is the plan under which the operational failures originally occurred. The answer does not depend on whether Plan B is maintained by the same employer (within the meaning of Code § 414(b), (c), and (m)) that maintains Plan A or an unrelated employer.

IRS Response: The Service representative indicated that two filings are required.