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AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

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COMMITTEE ON EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS

INTERNAL REVENUE SERVICE

MAY 6-8, 2010

*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 7, 2010. 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. We have used the term "Service" to refer to representatives of either the IRS or the Treasury.*

## 1. § 61 – Assignment of Income and Paid Time Off Leave Sharing

Employer provides a paid time off (PTO) leave sharing program where employees may waive future unearned PTO credits to donate to other employees with personal emergencies. It is the responsibility of the employee donating (waiving) the PTO credits to request the PTO waiver on an Employer approved form. Requests for waivers will only be considered for a bona fide emergency, which is defined as an unforeseen personal crisis or illness resulting in an urgent need for assistance. The crisis need not be for medical reasons. Waivers can only be made for the assistance of active employees.

PTO waivers will be based on future expected accruals. Upon receipt of request, Employer will initiate the request at the beginning of the next full pay period. The waiver's PTO accrual will be suspended for the hours requested (*i.e.*, if an employee donates 10 hours of PTO, their PTO accrual will be suspended for the required worked hours necessary to accrue 10 hours of PTO). Accrual of PTO will resume as normal upon completion of the waiver. The recipient will receive the total waived value of PTO upon receipt and processing of the request. If a waiving employee terminates employment while their PTO is suspended and prior to the waived PTO being earned, the unearned PTO value will be deducted from the terminating employee's remaining PTO balance prior to issuing the employee's final paycheck.

Assuming the PTO waivers are not provided for medical emergencies or major disasters, will the waiving employee be responsible for taxes on the requested waiver?

**Proposed Response:** No. The general rule is that the employee donating the leave is taxed, unless the leave-sharing plan is for "medical emergencies" as set forth in Revenue Ruling 90-29 or for major disasters as specified in Notice 2006-59 (in the latter two circumstances, the recipient of the leave time is taxed while the donor is not). The general rule stems from Section 61 of the Code, which provides that, except as otherwise provided by law, gross income means all income from whatever source derived, including compensation for services. As set forth in PLR 200626036 (March 7, 2006) and Information Letter 2005-0213 (December 5, 2005), a "basic principle of tax law is that a taxpayer's assignment to another person of his or her right to receive compensation for personal services does not relieve the taxpayer of the tax liability on the assigned income. See *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Eubank*, 311 U.S. 122 (1940), 1040-2 C.B. 209."

However, in the scenario set forth above, employees are waiving unearned PTO for services not yet rendered. They are not waiving or donating unused accrued time already earned. Because these employees are waiving a future right to PTO, this situation does not fall into the above general rule and the donating employee will not be taxed on his or her donation. Instead, the recipient of the PTO will be taxed at the value of the PTO donated.

This conclusion does not apply, however, with regard to employees who terminate employment prior to their waived PTO being earned. Since the value of the remaining balance of the waived time will be deducted from the earned PTO balance prior to issuing the employee's final paycheck, the value of the donated time will be included in the employee's gross income unless it meets the requirements of a medical emergency or major disaster.

**IRS Response:** The Service representative disagrees with the proposed response. In applying the assignment of income doctrine as it relates to compensation for services, whether the assignment relates to earned or unearned income is not determinative. An assignment of future compensation for services, including unearned PTO, is an anticipatory assignment of income. Therefore, in the

scenario set forth above, the value of the contributed PTO is income unless the requirements of Revenue Ruling 90-29 are met.

## 2. § 62 – Leave Sharing Programs

An employer maintains a leave sharing program. The program allows employees who suffer a medical emergency to apply for additional leave that has been donated by other employees into an employer-sponsored leave bank. The program defines a “medical emergency” as a medical condition of the employee or a family member of the employee that requires the employee to be absent for a prolonged period that extends beyond an employee’s normal paid leave of absence. Under the program, each employee who donates leave is able to designate the employee who is to receive the leave or designate it for general use of employees in need. Thus, the employer does not necessarily choose who receives the leave. Does the leave sharing program satisfy Revenue Ruling 90-29 (1990-1 C.B. 11) even though the employees may designate who receives the leave?

**Proposed Response:** Yes. The ability of employees to designate who is to receive the donated leave does not make the donated leave taxable to the donor employee. Instead, as provided under Revenue Ruling 90-29, the donated leave is taxable to the employee who receives the donated leave. This is true despite the provision in the IRS guidance regarding disaster leave sharing (Notice 2006-59 2006-2 C.B. 60 (2006)), which provides that with respect to a major disaster leave-sharing plan an employee donating leave will only have the donation excluded from an employee’s income if the plan does not allow a leave donor to deposit leave for transfer to a specific leave recipient.

**IRS Response:** The Service representative agrees with the proposed response provided the recipient employee is part of a designated class meeting the requirements of Revenue Ruling 90-29.

## 3. § 223 – Contributions to Health Savings Account

An employee elects family coverage for himself and his domestic partner under a high deductible health care plan (HDHP) for a calendar year. The domestic partner is not the employee’s dependent. The fair market value of the health coverage for the domestic partner is imputed as income to the employee.

**Question A:** What amount can the employee contribute to a health savings account (HSA) during the year such coverage is elected, disregarding any “catch-up contribution” that may be available to the employee?

**Question B:** Does the special rule for married individuals that limits the contribution amount that a husband and wife can make to an HSA apply to the employee and his domestic partner?

**Question C:** What amount can the employee’s domestic partner contribute to an HSA during the year such coverage is elected, disregarding any “catch-up contribution” that may be available to the employee’s domestic partner?

**Proposed Response A:** Since the employee has elected family coverage defined in Section 223(c)(4) of the Code as “any coverage other than self-only coverage” and Notice 2004-50 confirms that family HDHP coverage is HDHP coverage for one HSA-eligible individual and at least one other individual (whether or not the other individual is an HSA-eligible individual), the employee is treated as having family HDHP coverage and is eligible for contributions up to the HSA contribution limit for family HDHP coverage.

**Proposed Response B:** No. The HSA contribution limits imposed on married individuals do not apply to domestic partners. The Defense of Marriage Act provides that domestic partners will not, for federal tax purposes, be considered each other's "spouse." 1 U.S.C. § 7. Thus, the employee and his domestic partner are not subject to the contribution limits imposed on married individuals.

**Proposed Response C:** The employee's domestic partner is eligible to contribute up to the HSA contribution limit for family HDHP coverage for the same reason that the employee is eligible to contribute up to the HSA contribution limit for family HDHP coverage.

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

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

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

#### **4. § 401 – Determination Letter Submission for Pre-Approved Plan**

The deadline to submit a volume submitter plan for an EGTRRA determination letter expires April 30, 2010. If a new plan is adopted or a plan is taken over that wants to adopt a different volume submitter document, may the plan be submitted for a favorable determination letter using the six year cycle for pre-approved plans after April 30, 2010?

**Proposed Response:** New plans may be submitted under the pre-approved plan program until the Service officially closes the program for EGTRRA submissions. If a takeover plan was previously timely submitted for EGTRRA, it may be restated onto the new practitioner's EGTRRA volume submitter and submitted as a pre-approved plan until such time as the Service officially closes the program for EGTRRA submissions.

**IRS Response:** The Service representative disagrees with the proposed response. Currently, the Service does not permit an off-cycle filing for a pre-approved plan, even in the context of a plan merger. The Service representative stated that this is an issue that the Service is considering. The Service representative indicated that there is a special rule for individually designed plans and that it is considering applying that special rule to pre-approved plans as well.

#### **5. § 401 – Inclusion of Terminated Participant in Actual Deferral Percentage Test**

An individual was eligible to defer in the prior plan year (year 1), terminated employment in year 1, received post-severance regular pay in year 2, but could not make contributions to the plan from the post-severance regular pay in year 2 because the plan's definition of compensation for contribution purposes excluded all post-severance compensation. Must the plan include the person in the actual deferral percentage ("ADP") test for year 2?

**Proposed Response:** No, the individual does not need to be included in the ADP test. Although the participant had Section 415 compensation (testing compensation) in year 2, the employee did not have any compensation against which to defer under the plan's definition of compensation, and therefore, the employee is not an "eligible employee" for purposes of the year 2 ADP and actual contribution percentage ("ACP") tests. Alternatively, the plan could avoid including the participant in the year 2 ADP/ACP test by expressly excluding former employees from eligibility to make contributions under the plan.

**IRS Response:** The Service representative agrees with the proposed response. The employee would not be treated as an eligible employee. The Service representative stated, however, that it prefers the alternative provided in the proposed response whereby the plan avoids including a participant in the ADP test for year 2 by expressly excluding the former employee from making contributions rather than providing that the employee may not defer from particular compensation. The Service representative indicated that the alternative approach of expressly excluding the former employee is a clearer, cleaner alternative.

**6. § 401 – Timing of Volume Submitter Specimen Plan Submissions**

What is the timing for the next round of volume submitter specimen plans to be submitted for approval?

**Proposed Response:** Between February 1, 2011, and January 31, 2012.

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

**7. § 401(k) – Deferrals of Post-Severance Regular Compensation**

Must a safe harbor Section 401(k) plan permit former employees to defer from post-severance regular compensation?

**Proposed Response:** No, a safe harbor plan is not required to provide former employees with the opportunity to defer into the plan. Although a safe harbor plan must use a safe harbor definition of plan compensation, which includes post-severance regular compensation, the plan could exclude former employees from eligibility under the plan.

**IRS Response:** The Service representative agrees with the first sentence of the proposed response. A safe harbor plan is not required to provide former employees with the opportunity to defer into the plan. The Service representative did not provide an opinion on the second sentence of the proposed response.

**8. § 401(k) – Establishment of Alternative Defined Contribution Plan**

Company A and Company B are related brother-sister entities under common control under Section 414(c) of the Code. Both companies sponsor Section 401(k) plans (“Plans”) for their respective employees.

On December 31, 2009, 300 Company B employees were eligible to participate in Company B’s Plan. On December 31, 2010, the date of termination of Company B’s Plan, 200 Company B employees were eligible to participate in Company B’s Plan.

Several employees left Company B in 2010 and joined Company A. These former Company B employees now participate in Company A’s Plan and no longer actively participate in Company B’s Plan but maintain account balances. Consequently, Company B’s Plan currently has account balances for both active employees as well as former employees who have left Company B, including those who are now employed by Company A.

Company B would like to terminate its Plan in 2010 and make distributions to all employees, active and former, who still have account balances remaining in the Plan.

Treas. Reg. Section 1.401(k)-1(d)(4) provides, “A distribution may not be made . . . if the employer establishes or maintains an alternative defined contribution plan. For purposes of the preceding sentence, the definition of the term ‘employer’ contained in Section 1.401(k)-6 is applied as of the date of plan termination, and a plan is an alternative defined contribution plan only if it is a defined contribution plan that exists at any time during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. However, if at all times during the 24-month period beginning 12 months before the date of plan termination, fewer than 2% of the employees who were eligible under the defined contribution plan that includes the cash or deferred arrangement *as of the date of plan termination* are eligible under the other defined contribution plan, the other plan is not an alternative defined contribution plan.” (emphasis added)

Company A’s Plan would be an alternative defined contribution plan, unless the 2% exception applies. The following questions are raised with respect to the 2% exception:

**Question A:** How is the 2% threshold calculated and applied?

**Question B:** Must the number of Company B employees eligible to participate in Company A’s Plan at all times during the 24-month period beginning 12 months before the date of plan termination be considered, rather than only the number of Company B employees eligible to participate in Company A’s Plan as of the termination date? If so, then what significance, if any, does the italicized phrase above, “*as of the date of plan termination*,” found in Treas. Reg. Section 1.401(k)-1(d)(4), have on the calculation of the 2% threshold?

**Question C:** Should former Company B employees who now work for Company A and participate in Company A’s Plan, but who also still maintain account balances in Company B’s Plan, be included in calculating the 2% threshold? Or does this percentage calculation only include *active* Company B employees?

**Proposed Response to Question A:** In calculating the 2% threshold, the number of Company B employees eligible to participate in Company A’s Plan at all times during the 24-month period beginning 12 months before the plan termination date must always be considered. To begin, 2% of the number of Company B employees eligible to participate in Company B’s Plan as of the termination date (2% of 200 = 4 employees) should be calculated. Then the Plan must ensure that, at all times during the applicable 24-month period, fewer than four Company B employees were eligible to participate in Company A’s Plan. If fewer than four Company B employees were eligible to participate in Company A’s Plan at all times during the 24-month period, Company A’s Plan is not an alternative defined contribution plan.

**Proposed Response to Question B:** This phrase is given effect in calculating the 2% threshold as described in Proposed Response A above.

**Proposed Response to Question C:** Former Company B employees who now work for Company A and maintain account balances in Company A’s Plan should *not* be included in calculating the percentage of Company B employees eligible to participate in Company B’s Plan. Therefore, the exception requires that, at all times during the 24-month period beginning 12 months prior to the date of termination, fewer than 2% of *active* Company B employees eligible to participate in Company B’s Plan are eligible under Company A’s Plan. Employees who left Company B and joined Company A prior to Company B’s Plan termination are excluded from this calculation.

**IRS Response A:** The Service representative agrees with the proposed response to Question A describing the calculation of the denominator in the 2% fraction. The Service did not express an opinion on the other part of the response to Question A or to the responses to Questions B and C.

**9. 401(k) – Mid-Year Change to Safe Harbor Plan**

May an employer sponsoring a safe harbor Section 401(k) plan with a 3% nonelective employer contribution for at least one 12-month plan year make a prospectively-effective, mid-year amendment to the plan (1) to change the plan year to make the current plan year a short plan year and (2) to elect a safe harbor matching contribution in lieu of a safe harbor nonelective employer contribution for future plan years?

**Proposed Response:** Yes. Although Treas. Reg. Section 1.401(k)-3(e)(1) generally requires that the provisions satisfying Section 401(k)(12) of the Code remain in effect for an entire 12-month plan year, Treas. Reg. Section 1.401(k)-3(e)(3) allows an employer to change its safe harbor plan year in such a manner.

**IRS Response:** The Service representative agrees with the proposed response but reminds plan sponsors that they are required to satisfy the notice requirements for the following plan year. The notice must be provided in advance and it should discuss the plan year change.

**10. § 401(k) – Mid-Year Change to Safe Harbor Plan**

May an employer sponsoring a safe harbor Section 401(k) plan with a 3% nonelective employer contribution for at least one 12-month plan year make a prospectively-effective, mid-year amendment to the plan to convert the plan to a safe harbor Section 401(k) plan with a safe harbor matching contribution for the remainder of the plan year if (1) the compensation limit under Section 401(a)(17) of the Code is prorated for the portion of the plan year during which the 3% nonelective employer contribution is paid; and (2) the plan remains a safe harbor Section 401(k) plan for at least 12 months after the conversion?

**Proposed Response:** Yes. In substance, this action is the same as is currently allowed under Treas. Reg. Section 1.401(k)-3(e)(3).

**IRS Response:** The Service representative disagrees with the proposed response. The IRS has issued proposed regulations that address mid-year reductions in the 3% non-elective safe harbor formula if certain requirements are met. Specifically, the proposed regulations require a substantial business hardship, advance notice of the change and the satisfaction of the ADP test for the entire year. Solely amending the plan mid-year does not satisfy the proposed regulations. The Service representative also noted that the IRS has received comments on the proposed regulations and is actively working on finalizing the proposed regulations.

**11. § 402(c) – Tax Treatment of Rollovers**

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

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

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

## **12. § 402(f) – Direct Rollovers**

On September 28, 2009, the Service released Notice 2009-68, “Safe Harbor Explanation — Eligible Rollover Distributions” (Internal Revenue Bulletin 2009-39). The “Special Rules and Options” section of the safe harbor explanation provides as follows (emphasis added):

### **SPECIAL RULES AND OPTIONS**

#### **If your payment includes after-tax contributions**

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

*You may roll over to an IRA a payment that includes after-tax contributions through either a direct rollover or a 60-day rollover. You must keep track of the aggregate*

amount of the after-tax contributions in all of your IRAs (in order to determine your taxable income for later payments from the IRAs). *If you do a direct rollover of only a portion of the amount paid from the Plan and a portion is paid to you, each of the payments will include an allocable portion of the after-tax contributions. If you do a 60-day rollover to an IRA of only a portion of the payment made to you, the after-tax contributions are treated as rolled over last.* For example, assume you are receiving a complete distribution of your benefit which totals \$12,000, of which \$2,000 is after-tax contributions. In this case, if you roll over \$10,000 to an IRA in a 60-day rollover, no amount is taxable because the \$2,000 amount not rolled over is treated as being after-tax contributions.

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

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

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

Are these results consistent with existing law and Congressional intent?

**Proposed Response:** Based upon the language of the safe harbor explanation, a direct rollover would produce a different result than an indirect rollover with a less favorable tax treatment for a direct rollover. The safe harbor Section 402(f) notice is inconsistent with Section 402(c)(2) of the Code, which provides that if a participant is rolling over a portion of a distribution which includes employee after-tax contributions, “the amount transferred shall be treated as first consisting of the

portion of the distribution that is includible in gross income.” In addition, the language of the safe harbor Section 402(f) notice seems contrary to Congressional intent. The Job Creation and Worker Assistance Act (JCWAA) contained clarifying amendments to the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that amended Section 402(c)(2) to permit employee after-tax contributions to be rolled over. The JCWAA Committee Report specifically provides that when a distribution includes both pre-tax and after-tax amounts, the portion of the distribution representing the pre-tax portion will be treated as rolled over first:

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

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

**IRS Response:** The Service representative disagrees with the proposed response. The Service representative provided more detail on why it disagrees with the proposed response in its answer to Question 11.

### **13. § 402(f) – Direct Rollovers**

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

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

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

You may roll over to an employer plan all of a payment that includes after-tax contributions, but only through a direct rollover (and only if the receiving plan separately accounts for after-tax contributions and is not a governmental section 457(b) plan). You

can do a 60-day rollover to an employer plan of part of a payment that includes after-tax contributions, but only up to the amount of the payment that would be taxable if not rolled over.

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

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

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

If a distribution includes both pre-tax contributions and after-tax contributions, the portion of the distribution that is rolled over is treated as consisting first of pre-tax amounts (contributions and earnings that would be includible in income if no rollover occurred). This means *if you roll over an amount that is at least as much as the pre-tax portion of the distribution, you do not have to include any of the distribution in income.*

Under the general rules of Section 72, distributions are prorated. It should be noted, however, that EGTRRA amended Section 402(c)(2) to provide that after-tax contributions may be rolled over from an employer plan. Therefore, Section 402(c)(2) should govern when the matter pertains to the rollovers of after-tax account and since Section 402(c)(2) does not distinguish a direct rollover from a 60-day rollover, it should not bring different tax results.

**Proposed Response to Question A:** Section 402(c)(2) of the Code applies and thus, the participant could directly rollover only the pre-tax earnings to a qualified plan or a Section 403(b) plan.

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

**IRS Response:** The Service representative disagrees with the proposed response. The Service representative provided more detail on why it disagrees with the proposed response in its answer to Question 11.

#### 14. § 403(b) – Church Plans

An entity has a Section 414(e) church plan ruling with respect to its Section 401(a) defined benefit plan. The entity also maintains a Section 403(b) arrangement. The entity is not a Section 3121(w)(3)(A) or (B) “church” or “qualified church-controlled organization.”

Section 403(b)(1)(D) provides that Section 403(b)(12) applies unless the annuity contract is purchased by a “church,” which is defined by Section 403(b)(12)(B) as a “church” or “qualified church-controlled organization” within the meaning of Section 3121(w)(3)(A) or (B).

Section 410(c)(1)(B) exempts non-electing Section 414(e) churches from the participation and coverage rules of Section 410(b), except to the extent of the application of the pre-ERISA coverage and participation rules.

Notice 2001-46, 2001-2 CB 122, provides that until notice is provided regarding the application of the Section 401(a)(4) regulations to Section 414(e) church plans, such plans must comply with a good faith interpretation of Section 401(a)(4).

In applying the nondiscrimination provisions of Section 403(b)(12)(A)(i), what is the meaning of the phrase “in the same manner as if such plan were described in section 401(a)” with respect to Section 403(b) arrangements maintained by Section 414(e) churches? Does the language in Section 403(b)(12)(A)(i) embrace whatever exemptions exist under such Sections 410(c)(1)(B) and 410(d), and Notice 2001-46?

**Proposed Response:** Yes. Although Section 403(b) arrangements are generally not subject to the qualified plan requirements of Section 401(a), the Code provides that certain nondiscrimination provisions of Sections 401(a) and 410(b) will apply “in the same manner as if the plan were subject to section 401(a)” to Section 403(b) plans subject to the nondiscrimination provisions of Section 403(b)(12)(A)(i). The nondiscrimination requirements of Sections 401(a)(4) and 410(b) apply differently to non-electing church plans. Accordingly, to the extent a Section 414(e) church plan is subject to Section 403(b)(12), the participation and coverage rules of Section 410(b) and the nondiscrimination requirements of Section 401(a)(4) apply to the Section 403(b) arrangement in the same way as they would otherwise apply to a non-electing church plan subject to Section 401(a).

**IRS Response:** The Service representative generally agrees with the proposed response, but suggests that the last sentence of the proposed response be revised as follows: “Accordingly, in the case of a non-electing Section 414(e) church plan that is subject to Section 403(b)(12), the coverage rules of Section 410(b) and the nondiscrimination requirements of Section 401(a)(4) apply to Section 403(b) plans in the same way as they would otherwise apply to a non-electing church plan subject to Section 401(a). Thus, such a plan must be operated in accordance with a good faith, reasonable interpretation of the non-discrimination requirements.”

#### 15. § 403(b) – Eligibility

An employer maintains an ERISA covered Section 403(b) plan. As permitted under the Code, the Section 403(b) plan excludes employees who normally work less than 20 hours per week. *See* Code § 403(b)(12)(A). The employer employs 100 employees, 40 of whom are part-time employees (40% of the workforce). Does the exclusion of the part-time employees violate the coverage requirements under ERISA? (The Department of Labor has indicated that guidance on

this issue is within the purview of the Treasury Department. *See* ABA JCEB DOL Questions and Answers 2007, Q&A 7.)

**Proposed Response:** An employer may exclude employees who normally work less than 20 hours per week as a class from a Section 403(b) plan. Normally, ERISA limits exclusions based on service. ERISA § 202(a) (“No pension plan may require, as a condition of participation in the plan, that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of the following dates – (ii) the date on which he completes 1 year of service.”) Federal laws, however, are to be construed in a manner that does not abrogate a provision of one federal law and, therefore, because Congress specifically provided for the exclusion of employees who normally work less than 20 hours per week as a class from a Section 403(b) plan under the Code, this exclusion is permitted under both the Code and ERISA.

**IRS Response:** The Service representative disagrees with the proposed response. In the Service representative’s view, the Code and the regulations under Section 403(b) make it clear that this is not permitted. Section 403(b)(12)(A) of the Code permits a plan to exclude employees who normally work fewer than 20 hours per week. ERISA, on the other hand, prohibits any exclusion on account of service if the employee has worked at least 1,000 hours in the year. A Section 403(b) plan that excludes employees who work fewer than 20 hours per week also must satisfy ERISA, if the plan is subject to ERISA. The Section 403(b) regulations define when an employee may be excluded from a plan due to working fewer than 20 hours per week in a manner that is carefully tailored to permit the plan to satisfy ERISA. Under the regulations, an employee who normally works fewer than 20 hours per week may be excluded if and only if for the 12-month period beginning on the employee’s employment commencement date, it is reasonably anticipated that the employee will work fewer than 1,000 hours. For each plan year after the close of the 12-month period beginning on the employee’s employment commencement date, the employee must actually work fewer than 1,000 hours. Thus, the regulations do not permit an employee to be excluded due to normally working fewer than 20 hours per week after the employee has actually worked 1,000 hours.

#### **16. § 403(b) – Participation by Employees of For-Profit Subsidiary**

A “not for profit” Section 501(c)(3) non-governmental hospital has a “for-profit” subsidiary. The “for profit” subsidiary is structured as a single member LLC. Can the employees of the “for profit” subsidiary participate in the Section 403(b) Section 457(b) and Section 457(f) plan offered by the parent entity?

**Proposed Response:** Yes. Treas. Reg. Section 1.403(b)-2(b)(7) provides that an eligible employer is limited to a Section 501(c)(3) organization. Treas. Reg. Section 1.414(c)-5(b) provides that for purposes of Sections 414(b), (c), (m) and (o), a controlled group can include a tax exempt organization and any other organization under common control. The regulation does not specifically reference Section 403(b) and Section 457.

Nonetheless, because the LLC is not classified as a corporation under Section 301.7701-2(b) of the Procedures and Administration Regulations and has not filed IRS Form 8832, Entity Classification Election, it is treated as a disregarded entity for federal tax purposes under Treas. Reg. Section 301.7701-3(b). Announcement 99-102 and Treas. Reg. Section 301.7701-3(b) provide that when an entity is disregarded as separate from its owner, its operations are treated as a branch or division of the owner. The Service has issued PLR 200334040 stating that a for-profit LLC can participate in the parent’s Section 403(b) plan. If the Service is willing to treat the for-profit entity as being employees of the parent entity for Section 403(b) purposes, then it would appear that the

employees of the for-profit subsidiary would be treated as employed by the not-for-profit entity for all benefit purposes, which would include Section 457(b) and Section 457(f) purposes.

**IRS Response:** The Service representative's response is applicable to Section 403(b) plans only. The Service representative disagrees with the proposed response. The Section 403(b) regulations provide that a subsidiary or affiliate of an employer that is eligible to maintain a Section 403(b) plan also must satisfy the requirements of an eligible employer in order to maintain a Section 403(b) plan. In other words, both employers must satisfy the employer eligibility requirements to maintain a Section 403(b) plan.

#### **17. § 403(b) – Rollovers of After-Tax Contributions**

A Section 401(a) money purchase pension plan provides as a condition of employment that all the eligible participants contribute a certain percentage of their compensation on an after-tax basis, meaning that the plan has a mandatory after-tax contribution portion in each account. Does the language in a qualified plan permitting rollovers of after-tax contributions to Section 403(b) plans also include *mandatory* after-tax contributions?

**Proposed Response:** Yes. There is no distinction between mandatory and voluntary after-tax contributions. Thus, mandatory after-tax contributions also are subject to the Pension Protection Act requirement that requires a qualified plan permit rollovers of after-tax contributions to a Section 403(b) plan.

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

#### **18. § 403(b) – Status of § 403(b) Contracts Post-Termination**

When an entity distributes all fully paid individual annuity contracts upon the termination of its Section 403(b) plan, what is the status of such contracts? If the contracts remain Section 403(b) contracts, may vendors rely on employee representations regarding hardships, loans and similar items?

**Proposed Response:** A fully paid individual annuity contract distributed from a terminating Section 403(b) plan remains an individual Section 403(b) contract. Vendors may rely on employee representations for purposes of hardship, loans and similar items. Treas. Reg. Section 1.403(b)-10(a)(1) provides that the distribution of a fully paid individual annuity contract upon plan termination does not cause the contract to cease to be a Section 403(b) contract. However, the final regulations define a Section 403(b) contract as “a contract that satisfies the requirements of Section 1.403(b)-3,” including the requirement that the contract be issued pursuant to a written plan and that administrative functions be performed by someone other than a participant. There is no specific exception for a contract that an employee obtains in his individual capacity. Therefore, it is not clear under the regulations whether a contract distributed upon termination of a Section 403(b) plan will continue to be a Section 403(b) contract. Most vendors, however, are continuing to treat such contracts as Section 403(b) contracts. The final Section 403(b) regulations did not intend to disallow such individual Section 403(b) contracts, regardless of the fact that the contracts will no longer be issued pursuant to a written plan or that vendors must rely on individual annuity holder representations regarding hardships, loans and similar items.

**IRS Response:** The Service representative declined to answer this question, but noted that the plan termination is a permissible distribution trigger, regardless of whether the participant has a hardship or has terminated employment.

## 19. § 403(b) – Termination of § 403(b) Plans Containing Individual Annuity Contracts

An entity would like to terminate a Section 403(b) plan made up of only *individual* annuity contracts through two separate vendors. Will the contracts will be deemed “delivered” to the individuals if the individuals keep their original individual annuity contracts and vendors simply make a note that they are contracts from a terminated Section 403(b) plan? If the vendors agree to this, can the employer terminate the Section 403(b) plan without having to obtain the consent of any employees?

**Proposed Response:** Yes. Treas. Reg. Section 1.403(b)-10(a)(1) provides that in order for a Section 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. “Delivery” of a fully-paid individual insurance annuity contract is treated as a distribution. Treas. Reg. Section 1.403(b)-10(a)(1) permits the “delivery” of a fully paid individual insurance annuity contract upon termination of a Section 403(b) plan as a means of affecting distribution of the plan. The final Section 403(b) regulations do not specifically require the consent of the individuals to have their individual annuity contracts delivered to them, and therefore, an entity should be able to deliver such contracts and effect a termination of a Section 403(b) plan without obtaining the consent of each individual participant.

**IRS Response:** The Service representative agrees that the final Section 403(b) regulations do not require an individual to consent to have his individual annuity contract delivered to him in connection with the plan termination and that no further action is required to deliver the contract. By virtue of the plan terminating, the contract no longer relates to a Section 403(b) plan and thus, is delivered to the participant. An individual to whom such contract is delivered may maintain the Section 403(b) status of the contract by adhering to the requirements of Section 403(b) and the final Section 403(b) regulations in effect at the time the contract is delivered. The Service representative also noted that while delivery of the fully-paid individual insurance annuity contract is a distribution of such contract, it is not a taxable event until money is actually paid to the participant or beneficiary of the contract.

## 20. § 404(a)(6) – Timing of Deduction

For simplicity assume a calendar year plan year and tax year for a single-employer defined benefit plan. The employer makes a contribution on September 15, 2011. For funding purposes, the employer chooses to treat the contribution as a 2011 contribution. Can the employer choose to deduct the contribution in 2010?

**Proposed Response:** Revenue Ruling 76-28 provides that a contribution shall be “on account of” the prior year if “the payment is treated by the plan in the same manner that the plan would treat a payment actually received on the last day of such preceding taxable year of the employer” and either designates the payment or claims the deduction on its tax return. Revenue Ruling 77-82 allows an employer to deduct in 1975 a contribution made in 1976, which was used for funding in 1976 citing Treas. Reg. Section 11.412(c)-12(b)(2) and without mentioning Revenue Ruling 76-28. The cited regulation section says that the extent to which a contribution is deemed made for funding is “independent” from the rules for when a contribution is deductible for Section 404(a)(6) of the Code. Some have argued that Revenue Ruling 77-82 was a transition rule since it applied to a year before the ERISA funding rules took affect. However, PLR 7945115 took the same position with respect to a 1979 contribution deducted in 1978 but treated for funding purposes as a 1979 contribution – once again citing the Section 412 regulation but not Revenue Ruling 76-28. Some have argued that the Section 412 regulation works only one way (to allow funding treatment in the

prior year even if deduction treatment is for the later year. However, Revenue Ruling 77-82 does not indicate this treatment. Thus, pursuant to the regulation, an employer could make a contribution on Sept. 15, 2011, treat it for funding purposes as a 2011 contribution and yet treat it as a deduction on the 2010 tax return.

**IRS Response:** The Service representative commented that PLR 200517034 provides some boundaries to the rulings that are cited. The Service representative noted that while it may be possible that the contribution can be treated in the manner proposed, the plan sponsor is not entirely free to treat it in such a manner. The contribution must be made by the deadline required by Section 404(a)(6) and the contribution must be for services performed in 2010, not 2011. The Service has traditionally looked at the regulations as providing that while the rules of Section 412 are independent from the rules of Section 404, it does not mean that the rules of Section 404(a)(6) are independent from the rules of Section 412. Thus, the treatment under Section 412 may force the treatment under Section 404, but the treatment under Section 404 does not force the treatment under Section 412. The Service representative indicated that the Service is concerned that if a plan sponsor makes the contribution in 2011, but deducts it in 2010, the contribution will not be reflected on Schedule SB before the deduction is taken. So, when the contribution for the 2011 plan year is determined, the plan's funding may look lower than it would have looked if the plan sponsor had taken that contribution into account. The result is that the contribution for the 2011 year may be artificially higher.

## **21. § 409(h) – Put Option for ESOP**

The Service clearly has taken the position that the two 60-day put option periods in Section 409(h)(4) of the Code supersede the old 15-month put option period language in its 1977 regulations. The Department of Labor recently has taken the position in an audit that the 15-month definition in its 1977 regulations has not been superseded by Section 409(h)(4) of the Code. Can the Department of Labor still require the 15-month definition in an ESOP? The Department of Labor also stated that the put option has to be available to the distributee on *each day* of the 15-month period. If the 15-month definition has not been superseded by Section 409(h)(4) of the Code, is this interpretation correct?

**Proposed Response:** Section 409(h)(4) superseded the IRS' and Department of Labor's 1977 regulations defining the put option period for leveraged ESOPs. Section 408(b)(3) of ERISA provides that the loan must be to an "employee stock ownership plan" as defined in Section 407(d)(6) of ERISA. Section 407(d)(6)(B) of ERISA then says that the definition is subject to the requirements "as the Secretary of the Treasury may prescribe by regulation," thus granting direction on this issue to the Treasury Department. The Treasury Department's regulation then was superseded by Congress in 1978 by adding the language to Section 4975(e)(7) of the Code that requires satisfaction of Section 409(h) of the Code to meet the definition of an ESOP. There is no authority for the Department of Labor's position that the 15-month put option period applies *each day* during the period.

**IRS Response:** The Service representative commented that Employee Plans, Chief Counsel and Treasury have been meeting to evaluate the current guidance regarding ESOPs. They are interested in issuing additional guidance, possibly regarding one or more issues related to ESOPs, including coordination with the Department of Labor. The issue presented in this question relates to the change in Section 409(h)(4) of the two 60-day put options that supersedes the old 15-month put option period language in the 1977 regulations. If guidance is issued on ESOPs, this might be a question to be addressed. The Service representative specifically requested comments relating to this issue.

## 22. § 409(p) – Taking ESOP Securities into Account

**Facts:** Employer A is an S-corporation which sponsors an Employee Stock Ownership Plan. As permitted under Treas. Reg. Section 1.409(p)-1(b)(2)(v), the ESOP provides for prevention of a nonallocation year by transfer of employer securities of a participant reasonably expected to become a disqualified person into a separate portion of the plan that is not an ESOP.

What is the correct method for taking into account the securities transferred by the ESOP into the non-ESOP portion of the plan when calculating whether a participant is a disqualified person or the ESOP has a nonallocation year?

**Proposed Response:** The employer securities in the non-ESOP portion are not counted in either the numerator or the denominator when determining disqualified person status. They are excluded from the numerator but included in the denominator when determining whether there is a nonallocation year.

**Analysis:** *Disqualified Person Determination.* Under Treas. Reg. Section 1.409(p)-1(d)(1) a participant in an ESOP is a disqualified person (assuming no family aggregation applies) if either (1) the number of the person's deemed owned ESOP shares is at least 10% of the number of deemed owned shares in the ESOP or (2) the combined total of the person's deemed owned shares in the ESOP and the person's synthetic equity shares of the S-corporation is at least 10% of the total number of deemed owned ESOP shares and the person's synthetic equity shares in the S-corporation.

Shares of the S-corporation held in the non-ESOP portion of the plan are not "deemed owned" shares for the very reason that they are not held in the ESOP portion. Treas. Reg. Section 1.409(p)-1(e). In addition, such shares are not synthetic equity because they represent actual shares of the S-corporation, not a right to acquire or receive shares in the future (*see* Treas. Reg. § 1.409(p)-1(f)(2)) and they are not deferred compensation (*see* the last sentence of Treas. Reg. § 1.409(p)-1(f)(2)(iv)(A)). Therefore shares in the non-ESOP portion are not included in either the numerator or the denominator when determining whether a participant is a disqualified person.

*Nonallocation Year Determination.* Under Treas. Reg. Section 1.409(p)-1(c)(1), a nonallocation year occurs whenever disqualified persons own either (1) at least 50% of the number of outstanding shares in the S-corporation (including deemed owned shares) or (2) at least 50% of the sum of the outstanding shares in the S-corporation and the shares of synthetic equity owned by disqualified persons. The shares which have been allocated to the non-ESOP portion of the plan are outstanding shares for purposes of this determination because they have been issued and are held by a qualified plan. Thus the number of such shares is included in the denominator of the fraction used to determine whether there is a nonallocation year.

Under Section 318(a)(2)(B)(i) of the Code, shares in an employee trust described in Section 401(a) of the Code are excluded from ownership attribution. The exception to this exclusion in Treas. Reg. Section 1.409(p)-1(c)(2) only applies to "deemed owned" shares. Because the shares in the non-ESOP portion are not "deemed owned" shares or synthetic equity, they are not included in the numerator when determining a nonallocation year.

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

### 23. § 409(p) – Transfer of Shares to ESOP

Employer B is an S-corporation which sponsors an Employee Stock Ownership Plan. As permitted under Treas. Reg. Section 1.409(p)-1(b)(2)(v), the ESOP provides for prevention of a nonallocation year by transfer of employer securities of a participant reasonably expected to become a disqualified person into a separate portion of the plan that is not an ESOP. Employer B has adopted an ESOP which includes a provision for a non-ESOP portion to hold employer securities as permitted under this regulation. Employer B also has implemented this provision and transferred shares in plan year X from the ESOP to the non-ESOP portion in order to prevent a violation of Section 409(p). In subsequent plan year Y Employer B has determined that due to additional contributions of employer securities and other changes in the share allocations resulting from distributions and share transfers it is no longer necessary to retain shares in the non-ESOP portion of the plan in order to comply with Section 409(p) of the Code. Employer B proposes to move the shares from the non-ESOP portion back to the ESOP portion of the plan.

May Employer B move shares from the non-ESOP portion back to the ESOP portion of the plan if the transfer will not cause a violation of 409(p)?

**Proposed Response:** Yes. The permitted transfer under Treas. Reg. Section 1.409(p)-1(b)(2)(v) of employer securities of a participant reasonably expected to become a disqualified person into a separate portion of the plan that is not an ESOP is one means permitted to prevent a nonallocation year from occurring. Nothing in the final Section 409(p) regulations restricts or prohibits the subsequent transfer of shares from the non-ESOP portion back to the ESOP portion if no violation of Section 409(p) will result. Because shares in the non-ESOP portion of the plan accrue unrelated business taxable income on which the plan must pay income tax and shares in the ESOP portion do not, it is appropriate for the plan to transfer shares from the non-ESOP portion back to the ESOP portion whenever such a transfer will not result in a violation of Section 409(p).

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

### 24. § 409A – Application of Short-Term Deferral Exception

Company entered into an employment agreement with its CEO. Under the terms of the employment agreement, if the CEO's employment is terminated by Company without "Cause" or by the CEO for "Good Reason" either (1) within 6 months prior to a Change in Control, or (2) within 24 months following a Change in Control, the CEO is entitled to a severance payment. The "Good Reason" definition included in the agreement constitutes an "involuntary separation from service" as defined in the Section 409A regulations. The "Change of Control" definition included in the employment agreement is a Section 409A compliant definition. Does the severance payment described above fit within the short-term deferral exception if the employment agreement provides that the severance payment will be paid: (1) on or before March 15 of the tax year following the tax year in which the Change in Control occurs, in the case of a termination of employment within 6 months prior to a Change in Control; or (2) on or before March 15 of the tax year following the tax year in which the termination of employment occurs in the case of a termination of employment within 24 months following the Change in Control?

**Proposed Response:** Yes. The severance payment due on the CEO's termination of employment within 6 months prior to a Change in Control is subject to a substantial risk of forfeiture until the date on which the Change in Control occurs. As a result, the severance payment fits within the short-term deferral exception to Section 409A if it is paid on or before March 15 of the tax year following the tax year in which the Change in Control occurs.

The severance payment due on the CEO's termination of employment within 24 months following a Change in Control is subject to a substantial risk of forfeiture until the date on which the CEO's termination of employment occurs. As a result, the payment fits within the short-term deferral exception to Section 409A if it is paid on or before March 15 of the tax year following the tax year in which the CEO's termination of employment occurs.

**IRS Response:** The Service representative agrees with the proposed response if the non-occurrence of a change in control is a substantial risk of forfeiture under the particular facts and circumstances of this case.

## **25. § 409A – Acceleration of Benefits**

A service recipient maintains a nonqualified deferred compensation plan which is subject to Section 409A. The plan currently provides for the future payment of deferred compensation to ten different service providers. Pursuant to the discretionary plan termination and liquidation rules of Treas. Reg. Section 1.409A-3(j)(4)(ix)(C), may the service recipient unilaterally terminate and liquidate the plan on a service-provider-by-service-provider basis such that the deferred compensation is only accelerated for one service provider? Alternatively, must the plan be terminated with respect to all service providers in order to satisfy the requirements of Treas. Reg. Section 1.409A-3(j)(4)(ix)(C)?

**Proposed Response:** Treas. Reg. Section 1.409A-1(c) provides that the requirements of Section 409A are applied as if a separate plan or plans is maintained for each service provider. Therefore, the service recipient may unilaterally terminate and liquidate the plan on a service-provider-by-service-provider basis, provided that the plan termination otherwise complies with the requirements of Treas. Reg. Section 1.409A-3(j)(4)(ix)(C).

**IRS Response:** The Service representative disagrees with the proposed response. The service recipient must terminate and liquidate all plans that would be aggregated with the terminated plan if the same hypothetical service provider had amounts deferred under every plan maintained by the service recipient, including all entities treated as a single service recipient.

## **26. § 409A – Acceleration of Benefits**

A service recipient maintains a nonqualified deferred compensation plan which is subject to Section 409A. The plan currently provides that the plan may not be amended or terminated without the service provider's consent. Pursuant to the discretionary plan termination and liquidation rules of Treas. Reg. Section 1.409A-3(j)(4)(ix)(C), may the service recipient propose to terminate and liquidate the plan, subject to the service provider's consent?

**Proposed Response:** If the plan termination otherwise complies with the requirements of Treas. Reg. Section 1.409A-3(j)(4)(ix)(C), the service recipient may terminate and liquidate the plan. It is irrelevant that the service provider must consent to the termination.

**IRS Response:** The Service representative disagrees with the proposed response. Treas. Reg. Section 1.409A-3(j)(4)(i) provides that a service recipient may not provide a service provider with a direct or indirect election with respect to whether the service recipient will exercise its discretion to accelerate a benefit.

## 27. § 409A – Acceleration of Payment Due to Death or Disability

A nonqualified deferred compensation plan provides for payment under certain circumstances, other than death or disability, in a manner that complies with Section 409A. One participant in the plan dies and another suffers a disability within the meaning of Section 409A. *Scenario 1:* The participant dies or becomes disabled before the participant becomes entitled to plan benefits, which remain scheduled for payment at a later time, and before that time the plan is amended to accelerate the payment of benefits in respect of the participant. *Scenario 2:* The participant dies or becomes disabled after installment benefits to the participant have commenced, and the plan is amended after the death/disability to provide for a lump-sum payment of the remaining benefit. Does such acceleration cause the plan to fail to satisfy Section 409A?

**Proposed Response:** No, regardless when payment is made following the death or disability. Treas. Reg. Section 1.409A-3(j)(2) provides that the addition of death or disability (within the meaning of Section 409A) as a potentially earlier alternative payment event to an amount previously deferred will not be treated as resulting in an acceleration of payment. There is nothing in the regulation that requires the addition of the earlier payment to be memorialized before the death or disability, nor is there any compelling policy reason for such a requirement. The mere fact that the timing of the payment relative to the death or disability was not specified before the death or disability is irrelevant because a permissible acceleration under Treas. Reg. Section 1.409A-3(j)(2) could have specified that payment would be made at any given time after the death or disability.

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

## 28. § 409A – Anti-Substitution

A service recipient maintains a nonqualified deferred compensation plan which is subject to Section 409A. The service recipient unilaterally terminates and liquidates the plan in a manner which complies with the requirements of Treas. Reg. Section 1.409A-3(j)(4)(ix)(C). Therefore, among the other requirements, no payments in liquidation are made within 12 months of the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan and all payments are made within 24 months of such date. At some point during the three years following the plan termination, the service recipient adopts a new “replacement” deferred compensation plan. The replacement plan is of a type which would not be aggregated with the terminated plan under Treas. Reg. Section 1.409A-1(c). Do the anti-substitution rules of Treas. Reg. Section 1.409A-3(f) apply to this replacement plan?

**Proposed Response:** If the service recipient unilaterally terminates and liquidates the plan in a manner which complies with the requirements of Treas. Reg. Section 1.409A-3(j)(4)(ix)(C), there is no principled basis for the Service to argue that there is a “forfeiture or voluntary relinquishment of deferred compensation” within the meaning of Treas. Reg. Section 1.409A-3(f). The plan has been terminated and liquidated instead. Stated differently, the requirement in Treas. Reg. Section 1.409A-3(j)(4)(ix)(C)(5) that the service recipient not adopt a new plan that would be aggregated with any terminated and liquidated plan under Treas. Reg. Section 1.409A-1(c) at any time within three years following the date the employer takes all necessary action to irrevocably terminate and liquidate the plan essentially preempts the anti-substitution rules of Treas. Reg. Section 1.409A-3(f).

**IRS Response:** Under the facts presented in the question, it appears that there is no substitution because the new plan is not a substitute for a previously deferred amount.

**29. § 409A – Application of Notice 2010-6 to Arrangements that are Not Intended to be Subject to § 409A**

A service recipient established an arrangement that was intended to provide payments that, in all cases, satisfy the short-term deferral requirements of Treas. Reg. Section 1.409A-1(b)(4) (a “Short-Term Arrangement”). Under this arrangement, payouts are intended to be made concurrently with, or shortly after, each payout amount becomes vested. However, instead of using precise language regarding when a payment will be made following vesting (*e.g.*, “payment will be made on or before the 5th business day following the vesting date”), the arrangement uses language that is deemed to be ambiguous pursuant to Part IV.A.1. of Notice 2010-6, because the arrangement provides that “payouts will be made as soon as practicable following the vesting date.” Part IV.A. of Notice 2010-6 “applies to a plan provision that sets forth a permissible payment event under Section 409A(a) and Treas. Reg. Section 1.409A-3(a), but requires payment as soon as practicable following the permissible payment event, or under conditions substantially similar to as soon as practicable following the permissible payment event.” Accordingly, pursuant to Part IV.A. of Notice 2010-6, which specifically applies to arrangements that are subject to Section 409A (“409A Arrangements”), a Section 409A document failure will not occur merely because such arrangements include an ambiguity in the nature described above. If an ambiguity in the nature described above arises in the context of a Short-Term Arrangement, can a service recipient rely on the guidance set forth in Part IV.A. of Notice 2010-6 with respect to such arrangement, even though the arrangement is not a 409A Arrangement and, therefore, does not include provisions that set forth “a permissible payment event under Section 409A(a) and Treas. Reg. Section 1.409A-3(a)?”

**Proposed Response:** Yes. Although Notice 2010-6 specifically applies to 409A Arrangements, the guidance set forth in Part IV.A. of Notice 2010-6 may be relied upon with respect to Short-Term Arrangements. Part I of Notice 2010-6 provides that Part IV.A. of Notice 2010-6 clarifies that “as soon as practicable or substantially similar language” (“Covered Language”) is commonly included in plan documents and that the use of such language is permissible. The use of Covered Language, which is also commonly included in Short-Term Arrangements, does not become impermissible merely because such language is included in such an Arrangement. The degree of ambiguity in the Covered Language does not change merely because an arrangement is a 409A Arrangement, as opposed to a Short-Term Arrangement. Moreover, while Short-Term Arrangements are not subject to the requirements of Section 409A, such arrangements are addressed in the Treasury Regulations and other guidance issued under Section 409A. Neither the Treasury Regulations nor any other guidance issued under Section 409A provides that a different set of interpretive standards should apply with respect to 409A Arrangements and Short-Term Arrangements. Notice 2010-6 is not intended to break from the foregoing; thus, to the extent Part IV.A. of Notice 2010-6 is applicable to Short-Term Arrangements, the guidance set forth in Part IV.A. of Notice 2010-6 may be relied upon with respect to such arrangements.

**IRS Response:** The payment qualifies as a short-term deferral without application of Notice 2010-6, assuming the payment is made before the end of the 2½ month short-term deferral period. The plan is not required to specify a payment date in order for the payment to qualify as a short-term deferral. If the right to a payment is subject to Section 409A, nothing in Notice 2010-6 provides a method to modify the payment to satisfy an exception to Section 409A.

**30. § 409A – Change in Distribution Form**

An employer maintains a nonqualified deferred compensation that allows for distribution in four forms of annuities (Forms A, B, C, and D) that are actuarially equivalent for purposes of

Section 409A. An employee timely commences receiving benefits under the specified time under Form A in 2010. In 2011, the employee requests that the form of payment be changed to Form D on a prospective basis. May the plan allow the employee to change a form of annuity payment to another actuarially equivalent form of annuity payment after payment commences?

**Proposed Response:** Yes. Section 409A treats actuarially equivalent forms of annuity payment as being the same form of payment. *See* Treas. Reg. § 1.409A-2(b)(2)(ii). Therefore, a change from one form of annuity payment to another actuarially equivalent form of annuity payment after payment commences does not violate Section 409A. *See also* Treas. Reg. § 1.409A-6(a)(4)(i)(D) (allowing a plan to add forms of annuity payments that are actuarially equivalent).

**IRS Response:** The Service representative disagrees with the proposed response. By its terms, Treas. Reg. Section 1.409A-2(b)(2)(ii) is limited to a change that occurs before payments commence.

### **31. § 409A – Changing Severance Payment Timing**

An employment agreement for a specified employee of a public company contains Section 409A compliant definitions of Good Reason and Disability and provides that severance based on salary will be paid monthly over 36 months on a separation from service for termination without cause or resignation for Good Reason. Assume the monthly severance is \$50,000, paid before the 15th of each month, and total severance due is \$1,800,000. The individual's employment is terminated on June 30, 2011 in a calendar year fiscal year. Before termination, the Company revises the agreement with the individual's consent to say that severance owed during the short term deferral period will be paid in a lump sum within 30 days after employment ends, as will amounts that qualify as exempt from Section 409A under the two times/two year rule of Treas. Reg. Section 1.409A-1(b)(9)(iii) (*i.e.*, due during the 30 months ending December 31, 2013, subject to the two times limit). Assume that the change in payment timing preceded the termination of employment by a period that would argue against constructive receipt.

**Question A:** How much can be paid within the 30 days?

**Question B:** Against what payments does the service recipient debit the two times/two year earlier payment?

**Question C:** How much of the severance, if any, is subject to the six month delay?

**Proposed Response to Question A:** The service provider can receive within 30 days \$450,000 under the short term deferral rule (9 months, July 1 – March 15), plus \$490,000 under the two times/two year rule (assuming the qualified plan limit for 2011 is also \$245,000), for a total of \$940,000 because the amounts due within the short term deferral period or under the two times/two year rule are exempt from Section 409A and thus not subject to the prohibition on acceleration of deferred compensation.

**Proposed Response to Question B:** The “acceleration” of the two times/two year is deducted from amounts due during the first 30 months, so the individual's further payments are on hold until the 21st month, at which point the \$50,000 per month resumes, until he or she has received the remainder of the \$1,800,000. (It is not the 31st month, because the two times limit means that some of the amounts due within the two year period cannot be treated as exempt from Section 409A and so cannot be accelerated.) Alternatively, the rule could be that the two times/two year payments above and outside the short-term deferral amount are taken ratably from payments due

during the two year period, such that the \$50,000 per month would be reduced ratably to something like \$22,000 per month in months 10-30 (outside the short-term deferral period, inside the two year period), until the 31st month at which point the amounts revert to \$50,000 per month for months 31-36.

**Proposed Response to Question C:** Nothing is delayed for six months, because only the amounts in excess of the \$940,000 are subject to the six-month delay and those would not, in the pre-existing arrangement, be paid during the first six months. (The pre-existing arrangement amount was either \$300,000 (6 x \$50,000) or, as revised, \$940,000.)

The same flexibility within the short-term deferral and two times/two year rules would allow a lump sum payment to be moved around during the two year period.

**IRS Response A:** The Service representative disagrees with the proposed response. None of the payments are short-term deferrals under the facts presented because the payments were not designated as separate payments. Only \$490,000 may be paid in a lump sum under the two times/two years exception. If the payments had been designated as separate payments, then \$450,000 could be paid as a lump sum under the short-term deferral exception and \$490,000 could be paid as a lump sum under the two times/two years exception. The Service representative also noted that the doctrines of constructive receipt, economic benefit and assignment of income still may be applicable.

**IRS Response B:** The Service representative agrees with the proposed answer. The acceleration of the two times/two payments are deducted from the initial payments until the \$490,000 amount is reached. The Service representative noted that this occurs earlier than the 21<sup>st</sup> month as indicated in the proposed response. Once this occurs, then the \$50,000 monthly payments resume as previously scheduled.

**IRS Response C:** The Service representative agrees with the proposed response that no portion of the payment is subject to a six-month delay, but it is because the payments were not designated as separate payments. Therefore, \$1,310,000 is subject to Section 409A and must be paid as originally scheduled.

### **32. § 409A – Distribution of a Small Amount**

A nonqualified deferred compensation plan allows employees to elect a number of forms of distributions and provides: (1) that if as of the date payment is to commence the employee's benefit under the plan (and all similar plans that must be aggregated for purposes of Section 409A) is equal to or less than the limit under Section 402(g), the benefit will be paid to the employee in a single lump sum as of the date 60 days after the triggering event, and (2) that as of any subsequent January 1, if the employee's benefit under the plan (and all similar plans that must be aggregated for purposes of Section 409A) is equal to or less than the limit under Section 402(g), the benefit will be paid to the employee in a single lump sum as soon as possible after that date (but in all cases within the same calendar year). The nonqualified deferred compensation plan is the only plan of its type maintained by the employer for purposes of Section 409A. *See* Treas. Reg. § 1.409A-1(c)(2). An employee, who is scheduled to receive payment in installments upon a separation from service, has a separation from service on August 31, 2010 and as of August 31, 2010 has an account balance of \$16,300. If the employee's account balance is \$16,600 as of October 30, 2010 (the date 60 days after termination), will the plan violate Section 409A if it pays the employee a lump sum on October 30, 2010? If the employee's account balance is \$16,400 as

of October 10, 2010, will the plan violate Section 409A if it pays the employee a lump sum on October 10, 2010?

**Proposed Response:** In the case where the employee has an account balance of \$16,600 on October 30, 2010, the plan will violate Section 409A if it makes a lump sum payment because it is a prohibited acceleration. *See* Treas. Reg. § 1.409A-3(j)(4)(v). Although the amount would have been eligible for distribution as a small amount on the date of the employee's separation from service, the amount has increased and is no longer eligible for this treatment on October 30, 2010. In the case where the employee has an account balance of \$16,400 on October 10, 2010, the plan will not violate Section 409A if it makes a lump sum payment because the amount comes within the small amount rule and is paid no more than 30 days before the payment is scheduled to be made. *See* Treas. Reg. § 1.409A-3(j)(4)(v) (allowing acceleration for payment of small amount); Treas. Reg. § 1.409A-3(d) (providing payment up to 30 days before a specified payment date does not violate Section 409A).

**IRS Response:** The Service representative agrees with the proposed response. The account balance cannot be paid out if it exceeds the Section 402(g) limit at the time the payments are scheduled to begin. If the account balance does not exceed the Section 402(g) limit, it should be permissible to pay out the account balance pursuant to Treas. Reg. Section 1.409A-3(j)(4)(v) as described in the proposed response.

### 33. § 409A – Distribution of a Small Amount

A nonqualified deferred compensation plan allows employees to elect a number of forms of distributions and provides: (1) that if as of the date payment is to commence the employee's benefit under the plan (and all similar plans that must be aggregated for purposes of Section 409A) is equal to or less than the limit under Section 402(g), the benefit will be paid to the employee in a single lump sum as of the date 60 days after the triggering event, and (2) that as of any subsequent January 1, if the employee's benefit under the plan (and all similar plans that must be aggregated for purposes of Section 409A) is equal to or less than the limit under Section 402(g), the benefit will be paid to the employee in a single lump sum as soon as possible after that date (but in all cases within the same calendar year). The nonqualified deferred compensation plan is the only plan of its type maintained by the employer for purposes of Section 409A. *See* Treas. Reg. § 1.409A-1(c)(2). An employee who is a participant in the plan is scheduled to receive payment in five installments upon a separation from service with the first to be made 30 days after a separation from service and each subsequent installment to be paid on January 2. The employee has a separation from service on August 31, 2010. On September 30, 2010, the employee has an account balance of \$25,000 and the plan pays the employee \$5,000. On January 2, 2011, the employee has an account balance of \$20,000 and the plan pays the employee \$5,000. The employee then has an account balance of \$15,000. May the plan distribute the remaining amount in the employee's account on January 3, 2011 under the small amount cash out rule?

**Proposed Response:** No. Although the employee's account balance in the plan on January 3, 2011 is \$15,000, the exception allowing acceleration of payment for small amounts measures the entire amount distributed to an employee in a taxable year (generally the calendar year). *See* Treas. Reg. § 1.409A-3(j)(4)(v).

**IRS Response:** The Service representative disagrees with the proposed response. Section VIII.H. of the Preamble to the final Section 409A regulations provides that a service recipient may exercise discretion to cash out an account in accordance with Treas. Reg. Section 1.409A-3(j)(4)(v) at any

time that the amount deferred under the plan by a service provider is less than the Section 402(g) limit. Accordingly, the remaining \$15,000 may be cashed out.

#### **34. § 409A – Expiration of Plan**

If a noncompliant plan subject to Section 409A of the Code, such as an employment agreement that provides for certain payments upon a separation from service or change in control, expires by its term in 2009 or 2010, with no payment having been triggered under the terms of the plan, is it necessary nevertheless to correct the plan under Notice 2010-6 to avoid penalty under Section 409A of the Code?

**Proposed Response:** In such a case, where a plan expires by its term, correction is not required, provided that the parties may not avoid correction by agreeing to mutually terminate an agreement prior to the end of its term, other than in the case of a party refusing to renew via an evergreen provision, which nonrenewal would qualify as an expiration in this case.

**IRS Response:** The Service representative disagrees with the proposed response, assuming the amount is not subject to a substantial risk of forfeiture. Section 409A(a)(1) of the Code provides for immediate income inclusion and the application of additional taxes under Section 409A if at any time during a plan year the plan fails to comply with the requirements of Section 409A.

#### **35. § 409A – Named Fiduciary in a Top Hat Plan**

Are top hat plans required to maintain an “appropriate named fiduciary” pursuant to Section 503(h)(1) of ERISA?

**Proposed Response:** No. The requirement that an employee benefit plan maintain a named fiduciary is contained in Section 402(a)(1) of ERISA and top hat plans are specifically excluded from Part 4 of ERISA in Section 401(a)(1). However, Section 503(b) of ERISA states that “[e]very employee benefit plan shall establish and maintain reasonable procedures governing the filing of benefit claims . . . .” The Department of Labor has clarified that top hat plans are subject to Section 503 of ERISA in A-12 of its online Q&A regarding the Benefit Claims Procedure Regulation, stating that the “regulation establishes requirements for all employee benefit plans that are covered under Part 5 of ERISA, which would include top hat plans.” Thus, this guidance suggests that top hat plans are subject to Section 503(h)(1) of ERISA, which requires benefit plans to “establish and maintain a procedure by which a claimant shall have a reasonable opportunity to appeal an adverse benefit determination to an appropriate named fiduciary of the plan . . . .”

When faced with conflicting provisions, the specific language contained in Section 401(a)(1) of ERISA would ordinarily trump the general language contained in Section 503(h)(1) of ERISA based on accepted principles of statutory construction. Further, courts have noted the unique nature of top hat plans and declined to extend fiduciary status to top hat plan administrators. *See, e.g., Goldstein v. Johnson & Johnson*, 251 F.3d 433 (3d Cir. 2001) (rejecting the argument that a top hat plan’s administrator is also a fiduciary, noting that “a top hat administrator has no fiduciary responsibilities”).

**IRS Response:** The Service representative did not answer this question, but noted that this involves issues in the Department of Labor’s jurisdiction.

### 36. § 409A – Performance-Based Criteria

Company X has a bonus plan that provides that an employee will be paid a bonus of between \$0 and \$300,000 on a specified date three years in the future based on subjective performance criteria that are specified, bona fide, and relate to the employee's performance. Under the plan, a special committee of the Board (no member of which is a family member or under the effective control of the employee) will review the performance evaluations of the employee and if the employee receives an "A" evaluation, he or she will receive a bonus of \$300,000, if the employee receives a "B" evaluation, he or she will receive \$200,000, if the employee receives a "C" evaluation, he or she will receive \$100,000 and if the employee receives a "D" evaluation, he or she will receive \$0. Does such a plan comply with the rules for payment upon a "specified time or fixed schedule" under Treas. Reg. Section 1.409A-3(i)?

**Proposed Response:** Yes. Treas. Reg. Section 1.409A-3(i)(1) provides that amounts are payable at a specified time or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are nondiscretionary and objectively determinable at the time the amount is deferred. The regulations go on to provide that an amount is objectively determinable for this purpose if the amount is specifically identified or if the amount may be determined at the time payment is due pursuant to an *objective, nondiscretionary* formula specified at the time the amount is deferred. Under the fact scenario presented in the question above, the Board committee must apply the objective, nondiscretionary "A," "B," "C" formula in determining the amount of the bonus. However, it has discretion to determine whether an employee will receive an "A," "B," "C" or "D" evaluation – such an evaluation is a *subjective* evaluation of the employee's performance. However, Treas. Reg. Sections 1.409A-1(e)(1) and (2) permit the use of *subjective* performance criteria, provided that such criteria are bona fide and relate to the performance of the service provider and the person making the determination is not the service provider, his or her family member, or a person under the effective control of the service provider. Therefore, while the Board committee does retain discretion in assigning a grade to the employee's performance and therefore determining the amount the employee will receive under the plan, because the committee uses pre-established subjective performance criteria in making such a determination, the payment will be properly made under a "specified time or fixed schedule" payment event and will not violate Section 409A of the Code.

**IRS Response:** Assuming the service provider has a legally binding right to a deferred payment, the provision is compliant because the service recipient does not have discretion to change the payment date.

### 37. § 409A – Release of Claims and Installment Payments

On January 1, 2010, Employer and Employee M enter into an employment agreement to provide for payment of \$100,000 in six equal bi-monthly installments beginning on the 90th day following Employee M's separation from service provided that Employee M has executed and submitted a release of claims. The plan provides that each installment payment is to be treated as a separate payment under the plan. Employee M's payments do not qualify for the short-term deferral exception or the involuntary termination exception. Employee M has a separation from service on June 1, 2011. However, on August 30, 2011 (the 90th day following Employee M's separation from service) Employee M has yet to sign the release of claims. On November 15, 2011, Employee M executes his release of claims. If Employee M forfeits the installment payments otherwise due on August 30, 2011 and October 30, 2011, is he still entitled to his remaining four installment payments on their regularly scheduled dates?

**Proposed Response:** Yes. Treas. Reg. Section 1.409A-2(b)(2)(iii) provides that a plan may provide that the right to installment payments may be treated as a right to a series of separate payments. If Employee M fails to execute a release of claims until November 15, 2011, Employee M only forfeits any rights to the installment payments otherwise due under the plan on August 30, 2011 (the 90th day following Employee M's separation from service) and October 30, 2011, because he has not fulfilled a condition for the payment. Because the plan specifies that the installment payments are to be treated as a right to a series of separate payments, the fact that Employee M does not have a right to his August and October installment payments does not affect his right to his installment payments scheduled for December 30, 2011, February 30, 2012, April 30, 2012 or June 30, 2012. Once he executes and submits his release of claims on November 15, 2011, he has a right to receive all payments owed to him under the agreement after such date.

**IRS Response:** The Service representative agrees with the proposed response, provided the forfeited payments are not substituted with other payments. The arrangement also must not require that the release be submitted within the initial 90-day period and the arrangement must provide that the employee will forfeit any payments due prior to the employee executing and submitting the release.

### **38. § 409A – Release Timing**

Does the release requirement in the examples below mean that the agreement needs to provide any further timing rules for the severance?

**Alternative A:** An employment agreement contains a Good Reason definition that is broader than described in the Section 409A regulations. The agreement provides that 12 months of severance based on salary will be paid in a lump sum in the next regularly scheduled payroll after a release of claims is provided and becomes irrevocable. The agreement provides that an irrevocable release must be returned to the employer within 60 days after employment ends.

**Alternative B:** Assume the same facts as in Alternative A, but with a Section 409A compliant Good Reason definition.

**Alternative C:** Assume the same facts as in Alternative B, but the 60 day period is the employer's practice, not a term of the agreement.

**Proposed Response for Alternative A:** Arguably yes. Under Treas. Reg. Section 1.409A-3(b), the agreement should also provide that if the 60-day period crosses into the subsequent tax year, the payment must be delayed, even if the release was executed promptly, until that subsequent tax year. Compare the documentary compliance description in VI.B and Examples (3) and (4) under VI.C of the documentary compliance notice, Notice 2010-6 for a different method of complying with the timing rules, where payments are delayed until the end of a 60 or 90 period after employment ends. It would be helpful if the Service would put its informal position on the cross-years point into writing, perhaps in the next round of Notice 2010-6.

**Proposed Response for Alternative B:** No. The agreement is exempt from Section 409A and the timing is sufficiently specific to know that payment will be within the short term deferral period (or, at worst, within a combination of the short term deferral period and the two times/two year period).

**Proposed Response for Alternative C:** No. The practice is sufficient. The regulations should not be read to sweep in every offer letter, employment agreement or similar arrangement.

**IRS Response A:** The Service representative declined to answer this question.

**IRS Response B:** The Service representative agrees with the proposed response that the payments fit within the short-term deferral period provided the date that the release becomes irrevocable and the next regularly scheduled payroll date are within the applicable short-term deferral period. Whether the amount satisfies the two times/two year exception depends on whether the limits of that exception are met.

**IRS Response C:** The Service representative declined to answer this question.

### **39. § 412 – Life Insurance Policies**

Is it realistically possible under the present IRS administrative application of the law to have a qualified plan under Section 412(e)(3) of the Code that holds one or more interest-sensitive life insurance policies without having a side agreement with the insurance company issuing the policy as permitted by the regulations?

**Proposed Response:** As a practical matter, it is virtually impossible for any plan under Section 412(e)(3) of the Code that contains interest sensitive cash value life insurance to meet the requirements of Section 412(e)(3)(B)(C) of the Code without a side agreement of the type described in the IRS Employee Plans Newsletter of August 2007.

**IRS Response:** The Service representative agrees with the proposed response. The Service representative added that the proposed response is correct because it is generally not possible under such interest sensitive cash value life insurance policies to automatically apply experience gains against premiums.

### **40. § 412 – Listed Transaction for Defined Benefit Plan with Life Insurance**

Is a defined benefit plan which provides life insurance benefits to participants but has never been a Code Section 412(e)(3) plan (or a Code Section 412(i) plan) subject to Revenue Ruling 2004-20 for listed transaction purposes?

**Proposed Response:** Revenue Ruling 2004-20 was not intended to treat as a listed transaction life insurance which has been maintained in a defined benefit plan which at all times has been maintained as a traditional defined benefit plan even though the amount of the life insurance exceeds the permissible incidental death benefit amount by more than \$100,000 of coverage for one or more participants in such a plan.

**IRS Response:** The Service representative disagrees with the proposed response. Revenue Ruling 2004-20 was intended to apply to any plan in which the taxpayer deducts premiums for life insurance contracts as normal costs of the plan. Thus, in addition to its applicability to plans subject to Sections 412(e)(3) or 412(i) of the Code, Revenue Ruling 2004-20 also was applicable to defined benefit plans using split funding methodologies prior to the promulgation of the Section 430 regulations.

#### 41. § 412 – Waivers and Prefunding Balance

A condition of a granted waiver is that the plan must maintain a prefunding balance equal to the unamortized portion of the waiver. The Pension Protection Act requires the plan use the prefunding balance to remove a restriction. Assume this is done on March 30, 2010. Does the employer have to make an immediate contribution to the plan and declare it a prefunding balance to replenish the prefunding balance or can the employer wait until September 15, 2011? In essence, is the requirement to maintain a prefunding balance an every day of the plan year test or a once a year requirement?

**Proposed Response:** Under pre-PPA Section 412 of the Code, the Service apparently only looked at whether the required credit balance existed under the funding standard account at the time the Schedule B was filed. The elimination of the funding standard account does not change this result. The maintenance requirement remains a once a year test.

**IRS Response:** The Service representative stated that it will review this question as part of its consideration of changes to the funding waiver procedures when it updates those procedures for the Pension Protection Act. The Service representative also commented that the timing of the contribution is something that the individual taxpayer should discuss with the IRS. The money should be deposited in the plan as soon as possible, but if there are particular factual situations, they should be discussed with the IRS.

#### 42. § 414(c) and (m) – Aggregation of Controlled Groups and Affiliated Service Groups

X provides management services to Y. X and Y constitute a management-service affiliated service group. Z is a wholly owned subsidiary of Y. Y and Z constitute a parent-subsidary controlled group. X does not provide management services to, nor own an interest in, Z. Will Z be considered a member of the X/Y affiliated service group because Y and Z are members of the same controlled group; or, in the alternative, will X be considered a member of the Y/Z controlled group because X and Y are members of the same affiliated service group?

**Proposed Response:** Z is not a member of the X/Y affiliated service group. The IRS clarified in Field Service Advice 2948 (August 30, 1995) that the management organization must perform management functions on a regular and continuing basis for the related organization (Z) in order for the related organization to be considered a member of the affiliated service group. Because X does not provide management services to Z, Z is not a member of the X/Y affiliated service group. Additionally, X is not a member of the Y/Z controlled group. The controlled-group regulations aggregate parent-subsidary and brother-sister controlled groups when the parent is a member of a brother-sister controlled group. Treas. Reg. § 1.414(c)-2(a). The Regulations do not require aggregation of an affiliated service group with a controlled group when one of the members of the controlled group is also a member of an affiliated service group. Thus, X will not be considered a member of the Y/Z parent-subsidary controlled group solely because X and Y are members of the same affiliated service group. Similarly, Z will not be considered a member of the X/Y affiliated service group solely because Y and Z are members of the same controlled group.

**IRS Response:** The Service representative did not answer the question but pointed out that Field Service Advice cannot be relied on by any taxpayer.

#### 43. § 417(e) – Cash Balance Lump Sum Calculation

A cash balance plan with a normal retirement age of age 65 defines the interest crediting rate, which is credited for as long as the account is maintained in the plan, as the rate of return on the S&P 500. The plan defines the accrued benefit as a participant's projected account balance at age 65, expressed as a lifetime annuity commencing at that age. The plan defines the optional lump sum available to a terminated participant as equal to the present value, determined in a manner consistent with Section 417(e), of the accrued benefit. Is the lump sum payable to a terminated 40-year old participant equal to his current account balance?

**Proposed Response:** Yes. Even though the plan does not explicitly define the present value of the accrued benefit as the participant's current account balance, the definition is implied. In any event, the appropriate projection rate is the Section 417(e) rate because, on a risk-adjusted basis, all market rates of return are necessarily equivalent to one another. Therefore, the present value of the accrued benefit (the age 65 projected account balance) is equal to the current account balance.

**IRS Response:** The Service representative disagrees with the proposed response. In order to get the anti-whipsaw relief under the Pension Protection Act, the accrued benefit must be defined in relation to the account balance as opposed to the accrued benefit at age 65 with the reduction under Section 417(e) of the Code. The definition of the accrued benefit based on the account balance needs to be in place by the Section 1107 period under the Pension Protection Act, which for calendar year plans has passed. This deadline might be in the future for fiscal year plans. The plan sponsor needs to amend the plan within the Section 1107 period. If the Section 1107 period has passed, then the plan would need to use some kind of correction procedure. The Service representative did not answer the portion of the question relating to how to apply the whipsaw and the Section 417(e)(3) requirements.

#### 44. § 423 – Recognition of Income on Sale of Shares

Company XX has an employee stock purchase plan ("ESPP") that qualifies under Section 423 of the Code. The ESPP has a calendar year offering period, a date of grant of January 2 because the plan specifies a maximum number of shares that can be purchased by any one participant and a purchase price of 85% of the share price on the purchase date (December 31, the last of the offering period). The Company XX share price is \$100 on January 2 and \$150 on the following December 31 and Participant ZZ purchases 100 shares at \$127.50 per share. Three years after the purchase Participant ZZ sells the 100 shares for \$190 in a qualifying disposition after the Section 423 holding periods have been satisfied. Is the ordinary income to be recognized by Participant ZZ on the sale of the 100 shares \$15.00 per share (the amount of the discount at the date of grant) or \$22.50 per share (the amount of the discount at the time of the purchase) or \$0 (since the actual purchase price of \$127.50 exceeded the share price of \$100 on the date of grant)?

**Proposed Response:** \$15 per share. Treas. Reg. Section 1.423-2(k)(i) provides that when the price is less than 100% of the share price at date of grant (but not less than 85%) the ordinary income to be recognized on a qualifying disposition is the lesser of (A) the excess of the share price on the date of grant over the price paid under the option or (B) the excess of the share price on the date of sale over the price paid under the option. However Treas. Reg. Section 1.423-2(k)(ii) goes on to say that when the option price is not known on the date of grant, as is true in the example since the price is determined on December 31, then for purposes of calculating the ordinary income the option is deemed to be exercised on the date of grant. Therefore the shares, if purchased by an exercise of the option on the date of grant, would have been purchased for \$85 making the lesser of (i) and (ii) in Treas. Reg. Section 1.423-2(k)(A) or (B) equal to \$15.00.

**IRS Response:** The Service representative agrees with the proposed answer and clarified that Treas. Reg. Section 1.423-2(k)(3), Example 3 addresses this issue.

**45. § 457(b) – Contributions**

A hospital that is a tax-exempt employer under Section 501(c)(3) of the Code maintains a retirement plan under Section 403(b) of the Code and an eligible deferred compensation plan under Section 457(b) of the Code. An employee who is eligible for both plans but has not previously participated in the Section 457(b) plan makes an election under the Section 457(b) plan. After the first deduction under the Section 457(b) plan occurs, the employee realizes the mistake and asks the employer to cancel the amounts being contributed to the Section 457(b) plan in the middle of a month before another amount is deducted and contributed to the Section 457(b) plan. The employee also asks the employer to return the mistaken contribution to the Section 457(b) plan and to instead contribute the amount to the Section 403(b) plan. May the employer cancel the employee's Section 457(b) election mid-month or must the employer wait until the first day of the next month? May the employer return the amount contributed to the Section 457(b) plan if the facts and circumstances indicate the election was a mistake? May the employer contribute the amount to the Section 403(b) plan?

**Proposed Response:** The employer may cancel the employee's election in the middle of the month. In general, an election to make an elective contribution is not effective until the first day of the month following the date on which it is made. *See* Code § 457(b)(4). However, an employee may cancel contributions (may elect to contribute nothing) at any time and the election is effective immediately with respect to prospective compensation. *See* Treas. Reg. § 1.457-4(b) (“An eligible plan may provide that if a participant enters into an agreement providing for deferral by salary reduction under the plan, the agreement will remain in effect until the participant revokes or alters the terms of the agreement.”) If the employer reasonably determines the contribution to the Section 457(b) plan was a mistake (based on the facts and circumstances), the employer may return the contribution to the employee. *See* Revenue Procedure 2004-56, 2004-2 C.B. 376 (providing model plan language under Section 8.4 of the model plan allowing for a return of mistaken contributions). In addition, if the employer reasonably determines that the employee intended the amount to be contributed to the Section 403(b) plan, the employer can contribute the amount to the Section 403(b) plan. Factors that the employer may weigh in considering whether there was a mistake include the period of time that passes before the employee claims there was a mistake, the amount deducted, whether the employee previously participated in the plan, the employee's past behavior, and similar factors.

**IRS Response:** The Service representative did not answer the question, but expressed skepticism as to the factual statements in the question. The Service representative indicated that the facts may suggest that the employee changed his mind as to participation in the plan, rather than actually making a mistake of fact.

**46. § 3401(h) – Differential Wage Payments under HEART Act**

Does the definition of “Differential Wage Payment” under Section 3401(h) of the Code, as added by Section 105 of the Heroes Earnings Assistance and Relief Tax Act of 2008 (“HEART Act”), include, for all individuals on active duty for more than 30 days, *all* payments representing “all or a portion of the wages the individual would have received from the employer if the individual were performing service for the employer,” even if those payments are made in the first 30 days of active duty? Or, in the alternative, does the term “Differential Wage Payment” include only those

payments to an individual on active duty that are paid after 30 days have elapsed since the individual began active duty?

**Proposed Response:** Section 3401(h), as amended by the HEART Act, includes in the definition of “differential wage payment” all payments representing all or a portion of the wages the individual would have received from the employer if the individual were performing services for the employer, even if those payments are made in the first 30 days of active duty. While both the Code and IRS guidance issued in Notice 2010-15 are arguably silent (or at least ambiguous) on the issue, Congress’ intention in enacting new Section 3401(h) was, at least in part, to provide service men and women the ability to ensure their own financial security by allowing employers to permit the continued accrual of benefits when those individuals are called to serve their country. Section 105 of the HEART Act was also intended to simplify reporting requirements imposed on employers with respect to Differential Wage Payments and give some protection to the qualification of employers’ retirement plans. Including in the definition of Differential Wage Payments only those payments made after the 30-day period has passed would have the effect of both (1) limiting the ability of those on active duty to maintain their financial security, as well as (2) imposing substantial additional administrative burdens on employers who would be faced with different reporting and plan administration requirements based on whether a payment is made before or after the expiration of the 30-day period. It seems unlikely that Congress would have intended this effect in enacting this legislation. The more reasonable interpretation, and one that is consistent with the plain language of the statute, would be to include in the definition of Differential Wage Payments all such payments, whether made before or after the expiration of the 30-day active duty requirement.

**IRS Response:** Revenue Ruling 2009-11 addresses the employment tax aspects of military differential wage payments. The Revenue Ruling refers to a period of active duty that is scheduled to last for at least 30 days. The Revenue Ruling provides that the employer should look at the scheduled period of active duty. If the scheduled period is at least 30 days, then the payments are wages for withholding purposes beginning on Day 1.

#### **47. § 4980F – Requirement to Provide Section 204(h) Notice**

Pursuant to the terms of a collective bargaining agreement, a group of employees ceases to participate in Plan A and begins to accrue the same benefit under Plan B where the benefit accrued in Plan A and B are exactly the same. The benefit accrued in Plan A will be paid from Plan A and the benefit accrued in Plan B will be paid from Plan B, but the sum of the benefit will be the same as if the benefit had been paid from one plan. No assets are transferred. Is a 204(h) Notice required under these circumstances?

**Proposed Response:** A 204(h) notice would *not* be required due to the change in the collective bargaining agreement (even if an amendment to Plan A was required to cease benefit accruals under that plan). Treas. Reg. Section 54-4980F, Q&A 7 says if all or part of a plan’s rate of future benefit accruals or an early retirement subsidy depend on a provision in another document that is referenced in the plan, a change in the provision of the other document is an amendment to the plan. *See also* example 2 in Q&A 7. Thus, Q&A 7 permits Plan A to take into account the benefit provided under the collective bargaining agreement and such benefit has not been reduced. Additionally, based on reasonable expectations and all the relevant facts and circumstances at the time the amendment is adopted (as described in Q&A 8), it also can be concluded that benefits will not be reduced.

**IRS Response:** The Service representative disagrees with the proposed response. A Section 204(h) notice is required if the collective bargaining agreement required benefit accruals to cease under Plan A or if Plan A is amended to cease benefit accruals. A plan freeze is a significant reduction in the rate of future benefit accruals, which would trigger a Section 204(h) notice even if the collective bargaining agreement provides that employees will accrue similar or identical benefits under a separate plan, such as Plan B in this question.