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COMMITTEE ON EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS

INTERNAL REVENUE SERVICE

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The following questions and answers are based on an oral presentation made by IRS and Treasury officials at the Tax Section's Employee Benefits Committee meeting on May 9, 2008. The statements contained herein cannot be relied on even though they are printed as statements of the IRS. The questions were submitted by ABA members, and the responses were given at such meeting after explicit statements that their responses reflect the unofficial, individual views of the government participants as of the time of the discussion, and do not necessarily represent agency policy. This report on the responses was prepared by designated JCEB representatives, based on the notes and recollections of the JCEB representatives at the meeting and on a review of audio tapes of the meeting. This report has not been reviewed by IRS or Treasury. The questions were submitted in advance to the agency, and it was understood that this report would be made available to the public.

1. § 104, § 105 – Health Premiums After Termination of Employment

Corporation A maintains a self-funded (self-insured) health plan. Corporation A agrees to allow an executive, who is a highly compensated individual, to elect to continue to participate in the plan for life after termination of employment provided the executive pays 102% of the cost of the insurance elected by the executive (either 102% of single or family coverage) on an after-tax basis. This rate is the same rate as charged to individuals who elect to continue coverage under COBRA. Does this arrangement, which requires payment for the benefits on an after-tax basis, result in the executive being able to exclude the benefits under the health plan from income? Does this arrangement violate § 105(h)?

Proposed Response: The executive may exclude the benefits under the health plan from the executive's income. Section 104 provides that if an individual pays the fair market value of the cost of the coverage provided on an after-tax basis (or, if an employer pays the cost, the individual's income includes the cost of the premiums paid by the employer), the benefits received under such coverage are excluded from the individual's income. Therefore, if the executive pays the cost of the coverage (the COBRA rate) on an after-tax basis, the value of benefits received is not included in the individual's income. With respect to the second question, because this is permitted under § 104, the extension of coverage beyond the required COBRA period does not violate § 105(h).

IRS Response: If the COBRA premium is at least the fair market value of the coverage, then the Service representative agrees with the proposed response.

2. § 104, § 105, § 106, § 132 – Wellness Programs

An employer hires Provider A to run a wellness program for its employees. The wellness program is distinct from the employer's group health plans. Under the wellness program, if an employee completes a health risk assessment, Provider A sends the employee a $50 gift card. In addition, if the employee schedules a physical exam with the employee's physician, at which the physician discusses the health risk assessment with the employee and then sends it back to Provider A with the physician's signature, the employee receives a $100 gift card. The employer may contract with Provider A to have Provider A run additional wellness programs that offer gift cards as incentives to participate. If an employee completes both actions, are the gift cards taxable income? If so, does the employer or Provider A need to report the gift cards as taxable income?

Proposed Response: The gift cards are taxable income. Because Provider A is providing the gift cards to the employee, Provider A would report the gift cards on Form 1099-MISC. If the cumulative value of the gift cards Provider A gives to the employee is less than $600, then Provider A does not need to file a Form 1099-MISC on the employee. The gift cards are not compensation paid by the employer to the employee.

IRS Response: The Service representative agrees that the gift cards are taxable income, but disagrees that the gift cards should be reported on Form 1099-MISC. The Service representative stated that this is compensation that should be reported on Form W-2 by the original employer, not by Provider A who is acting as an agent in providing compensation to the employees.

3. § 106, § 152 – Treatment of Contributions by Employer to Accident and Health Plan

Employer Y maintains a cafeteria plan for its employees which allows for choices among medical, dental and group-term life insurance coverage and also permits employees to contribute to flexible spending accounts for health care reimbursement and dependent care expenses. The plan's definition of dependent child closely tracks the definition of qualifying child set forth in § 152(c) of the Code. Assume the plan also allows coverage for domestic partners of the employee and contains insured medical coverage under which coverage may be continued up to a certain maximum age.

For all plan dependents not satisfying the definition of qualifying child or the plan's definition of domestic partner, may Employer Y impute its portion of the premium for medical coverage into the employee's income and treat the employee's portion of the premium for such coverage as made on an after-tax basis without permitting the employee to demonstrate that the dependent satisfies the definition of a qualifying relative under § 152(d) of the Code?

Proposed Response: Yes, Employer Y may take this position.

IRS Response: The Service representative disagrees with the proposed response. The Service representative indicated that the employer must inquire about whether the covered individuals are dependents to determine the correct amount to report and withhold on with respect to the cost of this coverage.

4. § 125 – Application of COBRA to Health Flexible Spending Accounts

An employee has a health flexible spending account (FSA) under a Code § 125 cafeteria plan. The employee terminates employment mid-year with a balance in the FSA. Because termination of employment is a change in status, the employee elects to change his payroll deduction election to $0 per payroll period. The employee then elects COBRA with a $0 premium, so as to be able to "spend down" the balance in the FSA during the remainder of the plan year. Is this permissible?

Proposed Response: No. Although the employee may continue participating in the health FSA for the remainder of the plan year by electing COBRA, the "applicable premium" for the health FSA is the maximum amount available to the employee under the health FSA for the year. (*See* Treas. Reg. § 54.4980B-2, Q&A-8(f)(i).) The monthly premium would be 1/12 of this amount. The employee cannot eliminate the COBRA premium by electing to change his payroll deduction election to $0.

IRS Response: The Service representative noted that the employee was attempting to game the change in status rules by dropping to $0 and still having continued coverage. With respect to amounts incurred prior to termination of employment, however, the employee still has the right to receive reimbursement for those pre-termination expenses. The pre-termination expenses cannot be restricted.

5. § 162(m) – Performance Pay

Company A, a publicly traded company, adopts an annual incentive plan under which its CEO and other employees will receive an annual bonus if Company A meets certain performance standards. Under the annual incentive plan, an employee also receives an award if the employee dies or becomes disabled during the year (Company A pays a full award rather than a pro rata award that takes into account only the period during which the employee performed services). Assume the annual incentive plan in all other respects satisfies § 162(m) of the Code. Company A also enters into a change-in-control agreement with the CEO that provides the CEO will receive an amount equal to two times the CEO's base pay and the target amount of the annual incentive award if the CEO is involuntarily terminated for reasons other than cause within two years after a change in control. Does the additional requirement of an involuntary separation from service for reasons other than cause following a change in control take the payment of the annual incentive out of the performance pay exception under § 162(m)(4)(C) of the Code?

Proposed Response: Because the payment occurs only if there is an involuntary termination following a change in control, the change-in-control agreement does not take the payments under the annual incentive plan outside of the performance payment exemption under § 162(m)(4)(C). The double trigger requirement, which requires both a change in control and an involuntary separation from service for reasons other than cause, is more restrictive than merely a payment upon a change in control, which is permitted under the regulations. *See* 26 C.F.R. § 1.162-27(e)(2)(v).

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

6. § 162(m) – Shareholder Approval Requirement for Performance-Based Compensation

Treas. Reg. § 1.162(m)-27(e)(4)(vi) says that, if the compensation committee has authority to change the targets under a performance goal, the "material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal." If shareholders approve a performance goal in 2008, and awards are made on the basis of that goal in 2010 that are payable in 2015, must the material terms of the performance goal be reapproved by shareholders in 2013 in order for the awards to be performance-based compensation?

Proposed Response: No. The reapproval requirement applies only to awards granted (not received) in the fifth year or later after the year in which shareholders previously approved the performance goal.

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

7. § 401(a) – Notice Requirements for Automatic Contribution Arrangements

Revenue Ruling 2000-8 contained notice requirements for automatic enrollment features in 401(k) plans, including a requirement that each participant be notified annually of his or her compensation reduction percentage. The final 401(k) regulations issued in 2004 do not specifically address these notice requirements. In addition, the Pension Protection Act of 2006 includes different notice requirements for qualified automatic contribution arrangements (QACAs) under Code § 401(k)(13). If a 401(k) plan wishes to use automatic enrollment, but does not wish to meet the requirements for a QACA, what notice requirements should the plan comply with?

Proposed Response: The 401(k) plan can comply with the notice requirements for "eligible automatic contribution arrangements" in Code § 414(w)(4), even if the 401(k) plan does not intend to offer permissible withdrawals under Code § 414(w).

IRS Response: Generally, the Service representative agrees with the proposed response that plans may comply with the eligible automatic contribution arrangement (EACA) notice pursuant to § 414(w) of the Code even if the plan does not intend to offer permissible withdrawals pursuant to § 414(w), but the notice must be modified appropriately. The Service representative pointed out that the IRS issued a sample notice for QACAs, EACAs and ACAs on the IRS website in November 2007, which can be modified as needed. The Service representative also pointed out that the final regulations issued pursuant to § 401(k) of the Code address the annual notice requirement for compensation reductions in Treas. Reg. § 1.401(k)-1(e)(2)(ii).

8. § 401(a)(4) – Nondiscrimination in Automatic Contribution Arrangements

A plan sponsor is adding an automatic enrollment feature to its 401(k) plan for Group A employees only. The arrangement is not intended to be a qualified automatic contribution arrangement (QACA). Group A employees will have a default elective contribution of 3% of compensation. Group B employees, all of whom are highly compensated, are not subject to the automatic enrollment feature. Both Group A and Group B employees can affirmatively elect to make elective contributions to the 401(k) plan of up to 100% of compensation, subject to the limits in § 402(g) of the Code. Does the arrangement satisfy the nondiscrimination requirements in § 401(a)(4) of the Code?

Proposed Response: Yes. Treas. Reg. § 1.401(a)(4)-4(e)(3) includes "the right to make each rate of elective contributions" as an "other right or feature." Both Group A and Group B employees can affirmatively elect to make elective contributions of up to 100% of compensation. The automatic enrollment feature itself, or the absence of the automatic enrollment feature, is not an "other right or feature" subject to nondiscrimination testing under § 401(a)(4) of the Code.

IRS Response: The Service representative agrees with the proposed response. This arrangement would satisfy the benefits, rights and features test under § 401(a)(4) of the Code. It is permissible to have an automatic enrollment feature that is not available for one group of employees without failing the benefits, rights and features test pursuant to § 401(a)(4) of the Code.

9. § 401(a)(28) – Diversification Requirements

Under § 401(a)(28) of the Code, a "qualified participant" in an ESOP may make a diversification election during the 6 plan year period beginning in the plan year in which the participant reaches age 55 and completes 10 years of participation in the ESOP. If an employee meets the 55 + 10 rule but fails to make any diversification election during the qualified election period, then following the end of the 6 plan year qualified election period, is the ESOP participant automatically entitled to diversify, and if so, how much: 25% or 50%?

Proposed Response: No. Section 401(a)(28) requires an ESOP to permit a qualified participant, who has reached age 55 and has at least 10 years of participation in the plan, to diversify at least 25% of the participant's account in the plan each year for 5 years and 50% of the participant's account in the sixth year. Because § 401(a)(28) limits the diversification rights to this 6-year "qualified election period," § 401(a)(28) does not contemplate that the diversification rights extend beyond 6 years even if no election is made during such time. Thus, unless an ESOP is amended to so extend the diversification rights, once the qualified election period ends, the diversification rights end as well.

IRS Response: The Service representative agrees with the proposed response. Section 401(a)(28) does not extend the diversification rights beyond the 6 plan year period, so the diversification right would expire. The ESOP may voluntarily extend the diversification rights beyond the required statutory period. In such case, the diversification rights become a required plan term, with which the plan sponsor must comply.

10. § 401(b) – Determination Letter Filing Procedure Following a Plan Merger

Corporation C maintains Plan C, which is an individually designed 401(k) profit sharing plan. Corporation E maintains Plan E, which is also an individually designed 401(k) profit sharing plan. For purposes of periodic determination letter filings, Plan C is a "Cycle C" plan and Plan E is a "Cycle E" plan under Revenue Procedure 2007-44 (based on the EIN of the respective plan sponsors). Both plans are calendar year plans.

During 2007, Corporation E was merged into a wholly owned subsidiary of Corporation C. Following this corporate transaction, Corporation C became the "employer maintaining the plan" for purposes of Section 11 of Revenue Procedure 2007-44. Effective as of December 31, 2007, Corporation C amended Plans C and E, merging Plan E into Plan C. Thus, as of December 31, 2007, all of the assets and liabilities of Plan E were transferred to Plan C. Following the effective date of the merger, benefits that were provided under the terms of Plan E are provided under the terms of Plan C. Corporation C filed a final Form 5500 for Plan E for the year ending December 31, 2007 (the year in which all assets of Plan E were legally transferred to the control of Plan C).

Both Plan C and Plan E are the subject of a favorable GUST determination letter. With respect to each plan, a good faith EGTRRA amendment was timely adopted, and all amendments required to have been adopted through the end of 2007 in order to maintain the plans' qualified status were adopted. During 2008, any amendments required to maintain the plans' qualified status will be made to Plan C.

During 2008, Corporation C intends to restate Plan C consistent with the 2007 Cumulative List set forth in Notice 2007-94, and by January 31, 2009 will file Plan C with the IRS with a request for a favorable EGTRRA determination letter. As a part of its determination letter filing, Corporation C will include a copy of Plan E, the Plan E GUST determination letter, and all subsequent amendments to Plan E (along with the same type of documents for Plan C). Corporation C does not intend to separately restate Plan E for EGTRRA.

Assume that the IRS issues a favorable EGTRRA determination letter covering Plan C, amended and restated as described above.

Question A: With respect to Plan E, can Corporation C rely on the favorable EGTRRA determination letter that is issued with respect to Plan C, as amended and restated?

Question B: Following the merger of the two plans, what is Plan C's determination letter filing deadline?

Proposed Response A: Yes. The plan termination provisions of Section 8 of Revenue Procedure 2007-44 do not apply to this situation. (If such provisions applied, Corporation C would have to adopt any required plan amendments applicable as of Plan E's "termination date" and request a favorable determination letter no later than the later of (i) one year from the effective date of the termination, or (ii) one year from the date on which the action terminating the plan was adopted.)

Instead of Section 8, Section 11 of Revenue Procedure 2007-44 applies to this situation. Plan E is considered to have been timely amended and filed by virtue of its merger into Plan C and Plan C's subsequent timely Cycle C amendment, restatement and filing.

Proposed Response B: January 31, 2009. The plan merger provisions of § 11 of Revenue Procedure 2007-44 apply to this situation. Plan C's "post-change cycle" following the "cycle-changing event" of the corporate transaction is an "open cycle" under Section 11.03 of Revenue Procedure 2007-44, and since the period remaining in such open cycle is greater than 12 months, Plan C's post-change cycle submission period is not changed from its regular cycle submission period.

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

IRS Response B: The Service representative agrees that the determination letter filing deadline is January 31, 2009, but disagrees with the reasoning of Proposed Response B. As of December 31, 2007, the merger date, Plan C did not have an open cycle since Plan C's cycle does not begin until February 1, 2008. The Service representative indicated the correct reference to the general rule about plan mergers is § 11.01(1) of Revenue Procedure 2007-44.

11. § 401(b) – Delinquent Determination Letter Application

A profit sharing plan is a Cycle B filer. The profit sharing plan has a GUST determination letter, and the plan sponsor believes it has timely made all interim and discretionary amendments, beginning with the good faith EGTRRA amendment. However, the plan sponsor failed to file for a determination letter during the EGTRRA remedial amendment period for Cycle B filers, which ended on January 31, 2008. If the plan sponsor files for a determination letter now, the IRS reviewer may discover disqualifying defects, despite the good faith amendments. At that time, the remedial amendment period for correcting such defects will have ended. How should the plan sponsor file late for a determination letter?

Proposed Response: The plan sponsor should file a VCP submission for a "nonamender failure," *i.e.*, a failure to amend the plan to reflect a change in a qualification requirement within the plan's applicable remedial amendment period. The VCP submission must include the determination letter application (Form 5300 series) and the determination letter user fee. The plan sponsor also must pay the VCP fee for nonamender failures, which will be reduced by 50% if submitted within one year following the expiration of the Cycle B remedial amendment period on January 31, 2008.

IRS Response: The Service representative generally disagrees with the proposed response. The Service representative noted that this is not a nonamender failure. It is just a late filer.

If the plan did not have any disqualifying defects through the end of its cycle and it still does not have any disqualifying defects when it is submitted late, there is no reason to use EPCRS to correct because the plan does not have any operational defects. In this situation, the plan will have a small gap in its reliance because when it gets its second letter (which will be delayed due to the off-cycle filing), it will not cover the period from the end of the cycle, in this case, Cycle B, up until the date of the application.

The trickier situation is when the plan has a disqualifying defect. In those instances, the plan will be pointed toward one of the IRS' closing agreement programs, whether it is EPCRS, or a closing agreement program through the determination letter process, because the plan does not have the remedial amendment period to go back and correct the disqualifying defect.

12. § 401(c)(2) – Self Employed Individuals Earned Income

Treas. Reg. § 1.415(c)-2(b) defines compensation for self-employed persons as earned income under § 401(c)(2) of the Code, plus amounts deferred at the election of the employee under § 401(k) of the Code. Earned income under § 401(c)(2) of the Code includes a reduction for 50% of SECA liability. When is SECA liability determined?

Proposed Response: The SECA liability should be determined after the 401(k) contributions have been deducted from the person's income. The 401(k) contributions are then added back to arrive at 415 compensation.

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

13. § 401(k), § 415 – Compensation Following Severance from Employment

Employer X sponsors a 401(k) plan, an individually designed plan which is not intended to satisfy either the design-based safe harbor or the qualified automatic contribution arrangement safe harbor for its employees. In response to the previously informal IRS position against permitting elective deferrals of severance pay, it had its recordkeeper program the system to preclude deferrals from compensation received following termination of employment. In light of the final 415 regulations definition of compensation permitting limited post-severance compensation to be taken into account:

Question A: May Employer X amend its definition of 415 compensation to include regular compensation paid following termination of employment meeting the restrictions of Treas. Reg. § 1.415(c)-2(e)(3)(ii)?

Question B: May Employer X leave in place its system of excluding deferrals from all compensation paid following an employee's severance from employment?

Proposed Response A: Yes, since the 415 compensation definition applies solely for purposes of determining whether annual additions satisfy the limitations of § 415(c) of the Code, even though it does not permit employees to make elective deferrals with respect to any compensation paid following an employee's severance from employment.

Proposed Response B: Yes, because Treas. Reg. § 1.401(k)-1(e)(8) precludes deferrals following severance from employment based on compensation which does not satisfy the requirements of Treas. Reg. § 1.415(c)-2(e)(3). This does not mean, however, that the employer must take such compensation into account.

IRS Response A: The Service representative agrees with Proposed Response A. The employer must amend its definition of 415 compensation for regular compensation paid after termination of employment. It is permissive to amend for unpaid leave and similar categories of compensation.

IRS Response B: The Service representative generally agrees with the proposed response, but cautioned that when the employer does not want to be forced to differentiate the different types of compensation paid after severance from employment, the employer may run into the situation where ignoring regular pay that is paid after severance from employment throws the employer out of the § 414(s) safe harbor definition of compensation.

The Service representative noted that employers are not required to amend, but if they do not amend, the plan is no longer fits within the § 414(s) safe harbor.

14. § 401(k) – ADP Testing

An employer maintains a 401(k) plan. The 401(k) plan provides that an employee is immediately eligible to make elective contributions and is eligible for safe harbor matching contributions upon completing one year of eligibility service. The plan may be disaggregated into two parts: one covering employees who have completed less than one year of eligibility service and one covering employees who have completed one year of eligibility service. *See* 26 C.F.R. § 1.401(k)-1(b)(4)(vi), Ex. 2. There are employees who in one plan year are in both parts of the plan. For example, an employee hired on March 4, 2006 would be in the first part (covering employees who have not completed a year of eligibility service) from January 1, 2007 through March 3, 2007 and in the second part (covering employees who have completed a year of eligibility service) from March 4, 2007 through December 31, 2007. What portion of the employee's compensation and contributions needs to be counted in performing the ADP test on the portion of the plan for employees who have not completed a year of eligibility service?

Proposed Response: The employee's compensation and contributions from January 1, 2007 through March 3, 2007 would be counted in performing the ADP test for the 2007 plan year for the part of the plan covering employees who have not completed one year of eligibility service. *See* 26 C.F.R. § 1.401(k)-6 (providing in the definition of compensation, "The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending in the plan year. . . . A plan may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee . . . ."). *See also* 26 C.F.R. § 1.401(k)-2(a)(3)(ii)(B) (providing the plan needs to count only the portion of the employee's compensation earned prior to the employee completing one year of eligibility service).

IRS Response: The Service representative indicated that, in his personal opinion, the proposed response seemed reasonable. The Service representative cautioned that the answer ignores the issue of maximum entry date and whether that can be taken into account. The Service representative noted that the IRS is working on how the maximum entry date is taken into account for the disaggregation rules under § 401(k), § 410(a) and § 410(b) of the Code.

15. § 401(k) – Alternative Defined Contribution Plan

Company X and Company W are brother - sister corporations under § 414(c) of the Code. Both companies sponsor 401(k) plans for their respective employees. Company W is in the process of winding up its business and would like to terminate its 401(k) plan. As of December 31, 2007, Company W does not have any active employees. A few executives who worked at Company W have now become employees of Company X and are participating in Company X's plan.

Company W would like to adopt corporate resolutions in 2008, terminating its plan and making distributions to all former employees who still have account balances remaining, including those former employees who have account balances in excess of $5,000.

Treas. Reg. § 1.401(k)-1(d)(4) provides that a distribution may not be made under paragraph 1.401(k)-1(d)(1)(iii) of this section if the employer establishes or maintains an alternative defined contribution plan. The regulations define an alternative defined contribution plan as a 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.

The Company X 401(k) Plan would be an alternative defined contribution plan, unless the 2% exception applies. The question is how to calculate or apply the 2 % threshold.

Proposed Response: Company W would look at the number of employees which it has as of a date 12 months before the termination date. If more than 2% of that number were eligible to participate in Company X's plan then Company X's plan is an alternative defined contribution plan, and Company W cannot force distribution of account balances on plan termination. One does not look at the number of Company W's employees at the date of termination, since they have none.

IRS Response: The Service representative agrees with the proposed response. The rule looks at a 24-month period beginning 12 months before the plan termination date. Company W looks throughout 12 months before and 12 months after the termination date to determine whether less than 2% of employees are eligible to participate in the original plan, not the plan that is terminating. If the number of eligible employees is less than 2%, it is okay. If the number is over 2%, it does not meet the exception.

16. § 401(k) – Qualified Automatic Contribution Arrangements

For purposes of the qualified automatic contribution arrangement ("QACA") safe harbor and the exception for certain current employees under Prop. Treas. Reg. § 1.401(k)-3(j)(1)(iii), if a 401(k) plan previously included an auto enrollment feature of less than three percent, are the participants who were auto-enrolled under that provision (*i.e.*, at one or two percent) required to have their deferral percentage increased to three percent during the initial year in order to satisfy the requirements for QACA safe harbor status? For example, in the 2007 plan year, the plan sponsor previously auto-enrolled all eligible employees who were not making 401(k) deferrals to the plan; these eligible employees were auto-enrolled at 1%. Plan sponsor wishes to implement the QACA safe harbor in 2008.

Proposed Response: Yes, the participants previously auto-enrolled at a percentage lower than 3% must have their deferral percentage increased to 3% during the first year the plan wishes to take advantage of the QACA safe harbor. The employees' prior auto-enrollment is not considered an affirmative election to make or not make elective contributions under the proposed regulations. *See* the discussion in the preamble to the proposed regulations at 26 CFR 63147.

IRS Response: The Service representative agrees with the proposed answer. Participants who were previously automatically enrolled at a percentage lower than 3% must have their deferral percentages increased to 3%. The prior automatic enrollment election is not an affirmative election for purposes of the new safe harbor plan.

17. § 401(k) – Qualified Automatic Contribution Arrangements

For purposes of the qualified automatic contribution arrangement ("QACA") safe harbor, can the annual percentage increase be applied during the middle of a plan year, rather than at the end of a plan year? For example, a plan sponsor wishes to implement the automatic increase to coincide with annual merit increases given to employees. The plan is a calendar year plan, but the merit increases are effective October 1st. At all times, the minimum percentage requirements of Prop. Treas. Reg. § 1.401(k)-j(2)(ii) will be satisfied. For example, a newly eligible employee hired May 1, 2008 will be auto-enrolled at 3 percent. Unless the employee elects otherwise, the employee's deferral percentage will be increased to 4 percent on October 1, 2009, 5 percent on October 1, 2010, and so forth.

Proposed Response: Yes, the automatic increase implemented described above would satisfy the requirements of Prop. Treas. Reg. § 1.401(k)-j(2)(ii) because the minimum percentage for the regulatory initial period (May 1, 2008 to December 31, 2009) would never be less than 3 percent, the minimum percentage for the regulatory second period (January 1, 2010 to December 31, 2010) would never be less than 4 percent, and so forth.

IRS Response: The Service representative indicated that they would take this as a comment for a proposed regulation on mid-year changes to plans.

18. § 408(d) – Tax Treatment of Distributions

In effecting a spousal IRA rollover, a widow inadvertently failed to first withdraw her deceased husband's required minimum distribution ("RMD") for Year A, the year of death. To correct the excess contribution to her own IRA account, in January of Year B, before filing her tax return for Year A, she withdrew the amount of her deceased husband's RMD for Year A and wishes to withdraw the earnings thereon. These withdrawals are intended to avoid a penalty for excess contribution to her IRA account, pursuant to § 408(d)(4) of the Code. She intends to report the Year B corrective withdrawals as Year A income. The broker advises that it is not customary to calculate or distribute earnings on the late RMD and that it cannot treat the RMD as an excess contribution, as it was part of a rollover distribution from a decedent IRA into a beneficiary IRA, for which there is no limit imposed by the IRS. It intends to report the Year B distributions as Year B income. Please advise as to appropriate year for reporting income and as to necessity of withdrawing earnings.

Proposed Response: The rollover of the RMD was an excess contribution to the widow's IRA account. Pursuant to § 408(d)(4) of the Code, excess contributions to IRA accounts can be treated as never having been made if (1) they are withdrawn before the due date of the tax return, (2) no IRA deduction is claimed for the withdrawn amount, (*i.e.*, the withdrawn amount is included as income in the year of contribution, and (3) any earnings on the withdrawn contribution are also withdrawn and included in income for the year of the contribution. The widow, therefore, was required to withdraw the earnings on the excess contribution and both the widow and the broker are required to report the Year B corrective withdrawals as Year A income.

IRS Response: The Service representative agrees with the proposed response. The Service representative suggested looking at the Instructions to Form 5329 for more information.

19. § 409A – Acceleration of Benefits

Can a nonqualified deferred compensation plan, which is subject to § 409A of the Code and which originally stated that benefits would be paid at retirement, death, disability, or termination of employment, be amended to state that benefits will be distributed at the earliest of those events to occur if the employer/sponsor had always construed the plan to so state, without violating the anti-acceleration rule?

Proposed Response: Yes. Treas. Reg. § 1.409A-3(j)(2) and § 1.409A-2(b)(6) allow multiple payment events (*i.e.*, payment at the earlier of x or y) notwithstanding the employer's interpretation above.

IRS Response: Yes, the plan can be amended in accordance with the applicable transition rule relief.

20. § 409A – Acceleration of Payments

Can a nonqualified deferred compensation plan subject to § 409A of the Code allow some, but not all of the permitted accelerations of payment stated in Treas. Reg. § 1.409A-3(j)?

Proposed Response: Yes. The provisions of Treas. Reg. § 1.409A-3(j) are permissive, not mandatory.

IRS Response: The Service representative agrees with the proposed response. The Service representative also indicated that, as of right now, those provisions do not need to be put into the plan until they are actually used.

21. § 409A – Bona Fide Death Benefit

A plan established on January 1, 2006 provides that a named beneficiary or estate of highly compensated management employees will be paid a death benefit equal to two times final pay in a lump sum payment as soon as practicable after a participant's death. The participants in the plan receive no benefit while alive (the participants may name a beneficiary, but otherwise have no involvement in the plan). The participants do not pay premiums, and the benefit is paid out of the employer's general assets. Does the benefit under the plan constitute a bona fide death benefit for purposes of § 409A(d)(1)(B)? Will payment of the benefit be taxable income with respect to the beneficiary?

Proposed Response: The benefit is a bona fide death benefit for purposes of § 409A(d)(1)(B). *See* 26 C.F.R. § 1.409A-1(a)(5) (stating that for purposes of § 409A, a bona fide death benefit plan "refers to a plan providing death benefits as defined in § 31.3121(v)(2)–1(b)(4)(iv)(C)"); 26 C.F.R. § 31.3121(v)(2)–1(b)(4)(iv)(C)(1) ("Payments made under a nonqualified deferred compensation plan in the event of death are death benefits . . . only to the extent the total benefits payable under the plan exceed the lifetime benefits payable under the plan.")). The regulations define lifetime benefits payable as "the present value of benefits that could be payable to the employee under the plan during the employee's lifetime, determined under the plan's optional form of distribution or other election that is or was available to the employee at any time with respect to the amount deferred and that provides the largest present value to the employee during the employee's lifetime of any such form or election so available." 26 C.F.R. § 31.3121(v)(2)–1(b)(4)(iv)(C)(4). The benefit will be taxable income with respect to the beneficiary.

IRS Response: Yes, the benefit is exempt as a bona fide death benefit.

22. § 409A – Linked Plans

Is a potential for a noncompliant acceleration or untimely deferral created by a SERP formula which is offset, not by an actual defined contribution plan account balance (for which relief is provided in Treas. Reg. § 1.409A-2(a)(9) and Treas. Reg. § 1.409A-3(j)(5)), but by the cumulative employer contributions to the defined contribution plan, increased by a fixed rate of interest specified in the SERP? Does it matter whether the employer contributions are matching contributions, profit-sharing contributions under a fixed formula, or discretionary profit-sharing contributions? If there is a problem, would it be eliminated if an increase in the existing level of employer contributions could never reduce the existing SERP benefit, but would only reduce the rate of future SERP accruals?

Proposed Response: No principled basis appears to exist between SERP designs that offset actual defined contribution plan balances, and SERP designs that assume a specified rate of return. The latter form of design should therefore be held compliant as fully consistent with the intent of § 409A and not violative of any express prohibitions, without the need for any express regulatory relief.

IRS Response: The Service representative disagrees with the proposed response. The linked plan provisions have specific requirements that cannot be applied broadly by analogy. The linked plan provisions are limited to plans that are either (1) based on the same formula as the qualified plan, disregarding limits, or (2) an amount offset by some or all dollar for dollar of the qualified plan benefit. This does not fit into either of those categories. If the interest rate exceeds the returns on the defined contribution plan, the offset ends up being more than is actually in the plan.

23. § 409A, § 3121(v)(2) – Definition of Deferred Compensation

Does a plan under which an employee obtains a legally binding right to receive property in a future year provide for the deferral of compensation within the meaning of § 409A of the Code or § 3121(v)(2) of the Code if the right to receive the property will not vest before the property is transferred to the employee?

Proposed Response: No. Treas. Reg. § 1.457-11(d)(1) treats such a plan as a deferred compensation plan subject to § 457(f) of the Code only "if the date on which there is no substantial risk of forfeiture . . . precedes the date on which there is a transfer of property to which section 83 applies." The same principle applies for purposes of § 409A of the Code or § 3121(v)(2) of the Code.

IRS Response: This plan qualifies for the short-term deferral exception under section 409A.

24. § 409A – Distribution of Benefits

Can a nonqualified deferred compensation plan subject to § 409A of the Code allow a choice between lump sum or installment payments at retirement, but allow only lump sums at all other payment events, if the service provider makes the payment election at the time of the deferral election?

Proposed Response: Yes. This is allowed under Treas. Reg. § 1.409A-3(c)(2).

IRS Response: If the definition of "retirement" meets the age or age and service definition in the regulations, the Service representative agrees with the proposed response. The Service representative noted that this is the type of structure the IRS intended in the section of the regulations that discusses the toggles for payments upon separation from service. The basic rule is one time and form of payment per payment event. For a separation from service, it is permissible to pay in three different ways: (1) one way if the service provider separates within a defined period of up to two years following a change in control, (2) another way if the service provider met the age or age and service requirements specified in the plan, and (3) a third way if the service provider did not satisfy either (1) or (2).

25. § 409A – Distribution of Benefits

May a stock appreciation rights plan or similar plan that does not allow for participant deferrals specify in the plan that the distribution form will be based on the value of the participant's account upon separation from service? For example may a plan specify the following forms of distribution: (1) a lump sum distribution if the account is less than $15,000 as if the date of the participant's separation from service, (2) payment in five annual installments if the participant's account is between $15,000 and $50,000 as of the date of the participant's separation from service and (3) payment in ten annual installments if the participant's account is greater than $50,000 as of the date of the participant's separation from service.

Proposed Response: Yes. This type of objective nondiscretionary formula is permitted by Treas. Reg. § 1.409A-3(i)(1)(ii).

IRS Response: The Service representative disagrees with the proposed response. In the final regulations under the definition of installment payment, an installment payment will still be treated as an installment payment if the remaining value of a participant's account is cashed out if the present value falls below a predetermined amount, meaning the value must be tracked every time an installment payment is made. In other words, once the present value of the account falls below a predetermined amount, the participant is cashed out.

The Service representative noted, however, that after practitioners realized how this provision worked the IRS received many requests permitting a one time cliff payment. Practitioners indicated that they did not want to constantly measure the present value of the remaining installment payments. The Service representative indicated that, until further guidance, Notice 2007-78 permits a cliff payout, meaning if installment payments begin upon separation from service, the plan could provide that if the participant's account balance is less than a certain amount at the time payments are to begin, it will be immediately cashed out. If it exceeds the predetermined amount, it will be paid in installments. If, however, the schedule provides for different times and forms of payment based on a participant's account value, the payment schedule will not be considered a nondiscretionary schedule because money can always be added or taken away to receive payments pursuant to a specific schedule.

26. § 409A – Health Continuation Coverage

Treas. Reg. § 1.409A-1(b)(9)(v)(B) states:

> To the extent a separation pay plan (including a plan providing payments due to a voluntary separation from service) entitles a service provider to reimbursement by the service recipient of payments of medical expenses incurred and paid by the service provider but not reimbursed by a person other than the service recipient and allowable as a deduction under § 213 (disregarding the requirement of § 213(a) that the deduction is available only to the extent that such expenses exceed 7.5 percent of adjusted gross income), such plan does not provide for a deferral of compensation to the extent such rights apply during the period of time during which the service provider would be entitled (or would, but for such plan, be entitled) to continuation coverage under a group health plan of the service recipient under § 4980B (COBRA) if the service provider elected such coverage and paid the applicable premiums.

The regulations speak of "reimbursement" of medical expenses. Does this also cover employer payment of premiums with respect to a self-funded health plan?

Proposed Response: Yes. If an employer provides that the employer will pay all or a portion of an employee's premiums under a self-funded health plan during the period an employee is eligible for continuation coverage under COBRA, the payment of premiums is a "reimbursement" for purposes of the regulations. Based on the regulations, such payment of premiums would not be deferred compensation subject to § 409A.

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

27. § 409A – Mitigation of Severance Benefits

Is a mitigation provision permitted in a severance agreement that is subject to § 409A of the Code (*e.g.*, in the event the executive provides services to anyone other than the Employer during the 12-month period following termination, the amounts payable hereunder shall be reduced by the amounts the executive earns during such period as a result of such services)?

Proposed Response: Yes, a mitigation provision is permitted, because requiring that severance payments be offset against compensation the service provider receives from subsequent employment is a well-established business practice, grounded in true economic substance and business purpose (to provide severance to those in need of severance while avoiding a windfall to those who secure subsequent employment); and, consistent with the intent of the statute and akin to the offsets expressly permitted under the regulations for Social Security and disability benefits received by the service provider, it does not create opportunities to disguise the acceleration or postponement of deferred compensation payments.

IRS Response: Generally, the Service representative agrees with the proposed response. The Service representative indicated that this fact pattern is a forfeiture, rather than an offset, which is permissible under § 409A. The future employer does not owe the employee deferred compensation, so unless there is a reciprocal agreement with the new employer or something similar, the employee will have a loss of the deferred compensation. It is not going to change the time and form of payment, so it is treated as a forfeiture.

Similarly, the Service representative noted that if in receiving Social Security, an individual automatically loses a payment, it also would be a forfeiture. This does not, however, apply to any money or other benefits that the individual would receive from the employer who owes the individual the deferred compensation.

28. § 409A – Service Recipient Definition

Question A: Who is the "service recipient" for purposes of determining whether a nonqualified deferred compensation plan may offset benefits from a qualified employer plan or broad based foreign retirement plan for the purposes of Treas. Reg. § 1.409A-2(a)(9) and § 1.409A-3(j)(5)? Specifically, must the qualified plan be maintained by the "service recipient" as defined in Treas. Reg. § 1.409A-1(g) (all persons considered to be a single employer under Code § 414(b) or Code § 414(c)) or may the offset also be from other qualified plans or broad based foreign retirement plans such as those maintained by employers in a 50% control group?

Question B: If the service recipient for this purpose is limited to the Code § 414(b) and (c) definition, can and will a provision that offsets or reduces an amount payable under a nonqualified plan by an amount payable under a qualified plan of an employer that is not considered to be the service recipient be acceptable under Code § 409A under the provisions of Treas. Reg. § 1.409A-3(i)(1)(i) in the case of a single sum payment, or Treas. Reg. § 1.409A-3(i)(1)(ii) in the case of a series of payments?

Proposed Response A: For purposes of Treas. Reg. § 1.409A-2(a)(9) and § 1.409A-3(j)(5), service recipient should include employers in a 50% controlled group.

Proposed Response B: If the IRS disagrees with Proposed Response A, then an offset from a tax-qualified plan maintained by an employer in a 50% control group is permissible under Treas. Reg. § 1.409A-3(i)(1)(i) or Treas. Reg. § 1.409A-3(i)(1)(ii).

A non qualified deferred compensation plan that determines benefits based on a formula contained in a qualified employer plan, or that offsets some or all benefits provided by a qualified employer plan, must make sure that the offset does not result in an impermissible additional deferral or an impermissible acceleration of benefits in violation of Code § 409A. Treas. Reg. § 1.409A-2(a)(9) provides that certain actions with respect to a qualified plan or broad based foreign retirement plan will not cause an impermissible deferral under Code § 409A. Treas. Reg. § 1.409A-3(j)(5) provides that certain actions with respect to a qualified employer plan or broad based foreign retirement plan will not result in an impermissible acceleration in violation of Code § 409A.

In each case, the applicable section of the Treasury Regulations provides in relevant part as follows: "If a non qualified deferred compensation plan provides that the amount deferred under the plan is determined under the formula for determining benefits under a qualified employer plan…or a broad based foreign retirement plan…maintained by the service recipient…or that that amount deferred under the nonqualified deferred compensation plan is determined as an amount offset by some or all of the benefits provided under the qualified employer plan or broad based foreign retirement plan…." then certain actions with respect to the qualified plan will not violate Code § 409A.

No special definition of "service recipient" is used in either section. Thus, it appears that the definition contained in Treas. Reg. § 1.409A-1(g) applies.

In some instances, employees may move among related entities that are not considered to be the same employer because the requisite 80% ownership does not exist. In other parts of the 409A regulations, such as termination of employment and the definition of certain equity based compensation that is exempt from the provisions of 409A, the Treasury has recognized that an expanded definition of the service provider is necessary and that entities within a 50% and possible as low as 20% control group can be considered as the same employer. Similar considerations apply in this case.

Employers have legitimate business reasons for coordinating retirement benefits of employees of controlled entities event though the control is less than 80%. Further, there does not seem to be any significant opportunity for abuse by providing the same protection for offsets of benefits from qualified plans and broad based foreign retirement plans maintained by 50% owned entities as is provided to 80% controlled entities.

Treas. Reg. § 1.409A-3(i)(1)(i) provides that an amount is payable at a specified time or fixed schedule if objectively determinable amounts are payable at a date or dates that are nondiscretionary and objectively determinable and that an amount is objectively determinable if the amount is specifically identified or if the amount may be determined at the time the payment is due pursuant to an objective, nondiscretionary formula at the time the amount is deferred.

Treas. Reg. § 1.409A-3(i)(1)(ii) permits amounts to be paid by a nonqualified plan pursuant to a payment schedule to be limited by an objective non discretionary formula or specified amount that is not under the effective control of the service provider and is not subject to the exercise of discretion of the service recipient.

In the event that the qualified plan offset provisions do not apply, it seems that the same result may be able to be reached under the above regulations.

IRS Response A: The linked plan exception uses the term "service recipient," which means it picks up the regulatory definition. There is not an election under the linked plan exception like there is for service recipient stock. Plans must use the 80% definition of service recipient for the linked plan exception and cannot use a lower percentage.

IRS Response B: Offsets from a different employer's plan are not permitted. If a service recipient would like to offset from a different employer's qualified plan, this will not qualify for the linked plan exception. This offset somehow must comply with § 409A and, because transfers between qualified and nonqualified plans are treated as either payments or deferrals, the Service representative believes this will be problematic.

29. §409A, §451, and §457(f) – Deferred Compensation

An employer that is a tax-exempt organization establishes a deferred compensation plan subject to 457(f) structured as follows: The employer credits an amount each year to the plan (for example, $25,000 each year). If a participant ceases to perform substantial services for the employer before attaining age 60, the participant forfeits all amounts credited to the plan. At age 60, the amount in the participant's account vests and is included in the participant's income. The plan pays the participant an amount equal to the federal, state, and local income and employment taxes due on the vested amount, but the remainder (the basis) is retained in the plan. The plan provides the basis and earnings on the basis) will be paid one year after the participant has a separation of service (as defined under section 409A). The plan also provides that the employer will credit an amount each year to the plan after a participant attains age 60. For these credits (those made after the participant attains age 60) the employer pay the participant an amount equal to the federal, state, and local income and employment taxes due on the credit, with the remainder credited under the plan.

The following is an example of an employee in such a plan: Suppose an employee age 57 is selected to participate in the plan. The employer contributes $25,000 a year to participant's bookkeeping account in the plan. The participant performs substantial services for the employer through age 66. At age 60, the participant has a bookkeeping account equal to $90,000 ($75,000 in credits and $15,000 in earnings). Because the participant has performed substantial services through age 60, the plan pays the participant $40,000 to pay the federal, state, and local income and employment taxes due on the vested amount. The plan retains the remaining $50,000. In the year the participant attains age 61 the employer credits the participant with $25,000, $11,000 of which the employer pays to the participant to pay the federal, state, and local income and employment taxes due and the remaining $14,000 is credited to the participant's bookkeeping account. The same occurs in the years the participant attains ages 62 through 66. At age 66 the participant has a separation from service (as defined under section 409A). One year after the participant has a separation from service, the participant's bookkeeping account as a value of $160,000 (with a basis of $124,000 and earnings of $36,000).

Does the plan's payment of federal, state, and local income and employment taxes when the participant satisfies the substantial risk of forfeiture at age 60 comply with section 409A? Does the plan structure comply with section 457(f)? Would federal income taxes on the earnings accrued after a participant attains age 60 be delayed until one year after a participant has a separation from service based on the doctrine of constructive receipt?

Proposed Response: The plan's payment of federal, state, and local income and employment taxes when the participant satisfies the substantial risk of forfeiture at age 60 complies with the permitted payments under the regulations for section 409A. *See* 26 C.F.R. § 1.409A-3(j)(4)(vi) (permitting the payment of employment taxes); 26 C.F.R. § 1.409A-3(j)(4)(iv) (permitting the payment an amount equal to the amount necessary to pay federal, state, and local income taxes when a substantial risk of forfeiture lapses under section 457(f)).

The plan's structure satisfies section 457(f). The plan delays inclusion of the employer's contributions in the employee's income only to the extent there is a substantial risk of forfeiture. *See* Code § 457(f)(1)(A); Code § 457(f)(3)(B) (defining substantial risk of forfeiture). Once the substantial risk of forfeiture lapses (in the example above, at age 60), the amount in included in the employee's compensation (even if the full amount is not paid to the employee). *See* Code § 457(f)(1)(A) ("compensation shall be included in the gross income of the participant or beneficiary for the 1st taxable year in which there is no substantial risk of forfeiture"). After the substantial risk of forfeiture lapses, the contribution in subsequent years is included in the employee's compensation as required by section 457. *See* Code § 457(a)(1). The earnings on the amount in the plan are not subject to section 457 but rather are subject to section 409A and section 451 (governing constructive receipt).

Because the plan substantially restricts an employee's ability to receive the contributions and earnings under the plan, the employee is not in constructive receipt of the amounts and federal income taxes are delayed until actual payment. *See* 26 C.F.R. § 1.451-2(a) ("[I]ncome is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.").

IRS Response: The Service representative noted that the numbers in this question do not seem to work, but the general idea seems correct. When the participant has the income inclusion, it is permissible to pay out the amounts that would be due under federal, state, and local employment taxes at the time the substantial risk of forfeiture vests. The Service representative also commented that constructive receipt is a facts and circumstances test and indicated the Service would not answer that part of the question.

30. § 409A, § 457(f) – Substantial Risk of Forfeiture

A 457(f) plan contains a substantial risk of forfeiture that provides that a management employee will be paid an amount on a specified date on or after January 1, 2005 conditioned upon the employee's providing substantial services to the employer through that specified date. As of December 31, 2004, the employee has a legally binding right to the amount, but it is subject to a substantial risk of forfeiture. Is the amount subject to § 409A?

Proposed Response: Yes. An amount subject to a substantial risk of forfeiture under § 457(f) was not earned and vested as of December 31, 2004 and, therefore, is subject to § 409A.

IRS Response: The Service representative stated that a legally binding right to a future payment that as of December 31, 2004 remained subject to a substantial risk of forfeiture under §1.83-3(c) or a requirement to perform future services and therefore not earned and vested, is not excepted from section 409A under the grandfathering provisions. See Treas. Reg. § 1.409A-6(a)(2). However, the arrangement constitutes a short-term deferral excepted from coverage under § 409A provided that the payment is made in accordance with the rules defining a short-term deferral.

31. § 409A – Participation "Buy-Out"

On January 31, 2008, a U.S. person ("Programmer") who does not qualify as an "independent contractor" under § 409A of the Code and uses the cash receipts and disbursements method of accounting for tax purposes, is engaged by a U.S. company ("Company") under a "work-for-hire" arrangement to write a computer software program ("Program A") that will result in a product ("Product A") that will be owned in its entirety by, and will be sold by, Company. All of Programmer's services are performed in the U.S. The program is delivered by Programmer to Company on April 1, 2008. No further services of Programmer will be required. Company pays to Programmer $100,000 on January 31, 2008 at the execution of the services agreement and an additional $200,000 at delivery of Program A on April 1, 2008.

In addition to these fixed "milestone-based" compensation payments, Company grants Programmer a back-end 2% share in the net profits from Program A that is contingent upon Product A achieving Net Profits (a "Participation"). "Net Profits" is defined in the contract as net revenues (gross revenues less returns and allowance), less (i) the expenses of publishing, marketing and distributing Product A, and (ii) a cost allocation equal to 10% of Company's indirect costs (*e.g.*, overhead and interest costs) for the year(s) in which manufacturing and/or distribution activities occur.

The Participation payment, if any is due, will be paid (in arrears) within ninety (90) days following: (i) the calendar quarter end following the date on which Net profits is first achieved, for the first 8 calendar quarters; (ii) beginning on the second anniversary of the first calendar quarter reporting period, the subsequent semi-annual calendar period for the next 4 semi-annual calendar periods; and (iii) thereafter, the end of each calendar year period.

On November 1, 2009, Company also engages Programmer to write another computer software program ("Program B") which will result in a different product ("Product B"). With respect to Program B, Company pays $500,000 of fixed compensation, $150,000 on November 1, 2009 when the contract is executed and $350,000 on January 31, 2010 when Program B is delivered to Company, and, in addition, grants Programmer a Participation in Product B on the same terms and subject to the same payment timing schedule as described for Product A.

Both Product A and Product B achieve Net Profits and Participations are paid by Company to Programmer with respect to each Product as set forth in the contract.

The Participations paid by Company to Programmer with respect to Product A decline over time. Beginning 20 years from the initial publishing of Product A, the Participations payments due each year to Programmer have decreased to $1,000 or less. In order to reduce the costs of accounting for the Net Profits of Product A, computing Programmer's Participation with respect to that product and making the payment to Programmer, Company offers to "buy-out" Programmer's future Participations in Product A for $15,000. Programmer accepts this "buy-out" offer, executing a written agreement with respect to the payment, and Company closes out the Participations for Product A subsequent to the execution of the written agreement for the cashout.

However, Product B is very successful and Company will continue to pay Participations to Programmer related to that product subsequent to the "buy-out" of the Product A Participation.

Does the "buy-out" of Programmer's Participation right in Product A while maintaining a continuing obligation to pay Participations to Programmer on Product B satisfy the requirements for a limited cashout in Treas. Reg. § 1.409A-3(j)(4)(v)?

Proposed Response: Treas. Reg. § 1.409A-3(j) provides rules prohibiting or restricting the acceleration of payments. Within that subsection, an acceleration will not occur where a plan requires or provides the service recipient the discretion to require a mandatory lump sum payment of deferred compensation, provided: (i) the discretionary provision is evidenced in writing no later than the date of the payment; (ii) the payment results in the termination and liquidation of the entirety of the service provider's interest under the plan, including all plans which are aggregated under Treas. Reg. § 1.409A-1(c)(2); and (iii) the amount is not greater than the applicable dollar amount under § 402(g)(1)(B) of the Code.

In this instance, the requirements with respect to the timing of the written agreement and the amount limitation have been satisfied. The existing guidelines with respect to the aggregation of plans do not address the existence of separate agreements with respect to different projects, programs or products. The separate contract for Program/Product A should not be aggregated with the contract for Program/Product B because the concerns with respect to manipulating arrangements to avoid the application of § 409A of the Code are not existent in this situation. Therefore, the permitted buy-out of the Participations with respect to Product A would have no impact on the contract for Program/Product B, and the cashout by Company of the Product A Participations qualifies as a permissible acceleration.

IRS Response: The buy-out does not qualify for the limited cashout exception. The plan aggregation rules do not contain an exception for separate agreements with respect to different projects.

32. § 409A – Aggregation of Contingent Compensation Agreements

Company engages a Programmer to create Program C which results in Product C. Company agrees to pay Programmer an amount of fixed compensation payable upon delivery of Program C. Company also agrees to pay Programmer contingent compensation equal to a percentage of the Net Profits (as defined in the agreements), if any, from the sales of Product C. Once Net Profits have been achieved, Company will pay Programmer the contingent compensation pursuant to an objectively determinable and non-discretionary fixed schedule.

Under a separate agreement, Company engages the same Programmer to create Program D which results in Product D. Company agrees to pay Programmer an amount of fixed compensation payable upon delivery of Program D. Company also agrees to pay Programmer contingent compensation equal to a percentage of the Net Profits (as defined in the agreements), if any, from the sales of Product D. Once Net Profits have been achieved, Company will pay Programmer the contingent compensation pursuant to an objectively determinable and non-discretionary fixed schedule.

Company makes an impermissible distribution to Programmer with respect to one of the contingent compensation payments due for Product C.

Will the non-compliance with § 409A with respect to the single contingent compensation payment related to Product C taint all of the future contingent compensation under the agreement for Program C/Product C and also contaminate all of the future contingent compensation under the agreement Program D/Product D via the aggregation rules?

Proposed Response: Treas. Reg. § 1.409A-1(c)(2) provides rules with respect to the aggregation of plans, including account balance and non-account balance plans. In essence, this regulation provides that all deferrals of compensation with respect to the service provider under all plans of the service recipient are (with some exceptions) treated as deferred under a single plan. The exceptions from the general aggregation rule are made with respect to separation pay plans, in-kind payments and reimbursements, split-dollar life insurance arrangements, modified foreign income, stock rights and dual status arrangements (*i.e.*, an arrangement as an employee and a separate arrangement as an independent contractor).

The existing regulations do not address situations where the service provider and service recipient enter into multiple arrangements with respect to completely separate services (*e.g.*, Example C's separate Programs and resulting Products). Multiple agreements between the same parties with respect to separate projects should not be aggregated because the concerns with respect to manipulating arrangements to avoid the application of § 409A of the Code are not existent in this situation. Thus, a violation of § 409A of the Code with respect to Product C would have to be analyzed to determine whether a violation has occurred with respect to all deferred compensation under that separate Program C/Product C contract, but would not constitute a violation of any payments pursuant to the contract with respect to Program/Product D.

IRS Response: The Service representative disagrees with the proposed response. If the service provider, or employee, is providing services to that employer, all deferred compensation that the employee has from that employer that is of that type is considered one plan. It is not permissible to divide up the deferred compensation based on who the client is or the type of service the employee is providing. If the compensation is deferred and it is an elective account balance plan, it is all one plan. Similarly, if it is a non-account balance plan, it is all one plan.

33. § 409A – Transition Rules

Under the transition rules, plan sponsors are supposed to operate deferred compensation plans in accordance with § 409A but need not conform them to the documentary requirements of § 409A until December 31, 2008. If in 2008 a plan provides for payment of § 409A deferred compensation on a Change in Control as defined in the plan, but the definition has not yet been conformed to the definition of a change in control event in Notice 2005-1 or the Final Regulations, and a Change in Control as defined in the plan occurs in 2008, will the plan be § 409A compliant if the plan sponsor administers the Change in Control provision as if it contained the definition of a change in control event in Notice 2005-1 or the Final Regulations, or is that in effect a change in a time of payment that may only be made in the preceding calendar year under the transition rules? In other words, was the plan sponsor required to conform the definition of Change in Control to the § 409A definition in 2007 despite the ostensible deferral of the documentary compliance date until December 31, 2008?

Proposed Response: In analyzing this question, it is useful to distinguish three different fact-situations: (i) the corporate event would be a "Change in Control" under the nonconforming plan definition (the "Plan Definition") and under the definition in Notice 2005-1 or the Final Regulations (the "409A Definition"), (ii) the corporate event would be a "Change in Control" under the Plan Definition but not under the 409A Definition and (iii) the corporate event would be a "Change in Control" under the 409A Definition but not under the Plan Definition.

In the first fact-situation, there would not appear to be any impediment to delaying the amendment of the plan to substitute a conforming § 409A definition until the end of 2008 (even after the date of the "Change in Control") and paying out or commencing payment of the "Change in Control" benefit in 2008 (subject to the 6-month delay for "specified employees").

In the second fact-situation, payout could not be made by reason of the corporate event consistent with § 409A since the corporate event would not be one of the permissible payment events under § 409A. The plan could be amended to substitute a conforming § 409A definition by December 31, 2008 but under the facts of this second fact-situation that would not permit a payout to be made. If the payout were nevertheless made pursuant to the Plan Definition, the penalties for failure to comply with § 409A would apply to non-grandfathered amounts.

In the third fact-situation, it could be argued that it is too late for the conforming § 409A definition to be adopted in 2008 because the corporate event would not have been a payment event under the Plan Definition so that the substitution of the conforming § 409A definition would essentially be adding a new payment event accelerating payment to 2008. However, under the reasoning of § III.C.3. of IRS Notice 2007-78 (relating to the retroactive adoption of permissible payment event definitions), it would appear that the plan could be operated in accordance with the § 409A Definition during 2008 (permitting payments to be made in 2008 by reason of the "Change in Control") and the conforming § 409A definition could be substituted for the Plan Definition through an amendment adopted by the end of 2008, notwithstanding that the corporate event would not have been a payment event under the Plan Definition. Although this provision of IRS Notice 2007-78 was revoked and superseded by IRS Notice 2007-86, the reasoning of IRS Notice 2007-78 should still apply allowing a conforming § 409A definition to be substituted by December 31, 2008 and allowing the plan to be operated in accordance with the 409A Definition during 2008 even if that results in a payout during 2008 that would not have been payable under the Plan Definition.

IRS Response: The way the transition works is that a plan sponsor should follow the terms of the plan to the extent the terms comply with Notice 2005-1. To the extent not addressed in Notice 2005-1, a plan sponsor should use a reasonable good faith interpretation of the statute. Since Notice 2005-1 includes a definition of change in control, if the plan's definition is broader than the definition in Notice 2005-1, the plan has a non-compliant plan term. It would be similar to a plan containing a haircut provision. As long as the plan sponsor does not apply the too broad part of the change in control definition, it is okay. The plan sponsor needs to apply the part of the definition that is not too broad because that is now the plan's term. If the Company has a change in control that meets the IRS' change in control definition, the plan needs to make the payment. If the Company has a change in control that meets the plan definition but not the IRS definition, the payment should not be made. Plans need to operate under the current plan terms that actually comply with § 409A unless the terms have been changed in accordance with the transition rules. Merely having a definition of change in control that is too broad today does not cause the plan to fail to comply with § 409A.

34. § 409A – Transition Rules

If a company adopts a new plan in 2005 (after the effective date of § 409A and during the transition period) that contains provisions that clearly contravene the provisions of § 409A (such as provisions that permit the company to accelerate deferred compensation payments or further defer compensation payments without adhering to § 409A's re-deferral rules), but the company operates the plan in compliance with § 409A (*i.e.*, does not accelerate or further defer any payments), has the company operated the plan in good faith compliance with Notice 2005-1 and § 409A of the Code such that the transition relief from the documentary compliance requirements of § 409A is available and no § 409A violation has occurred?

Proposed Response: Yes, documentary compliance is not required as long as the employer/employee can demonstrate that the impermissible provisions were not followed in operation. The Preamble to the Final Regulations does not require that the plan document be amended to comply with § 409A for periods prior to the Final Regulations' effective date which is January 1, 2009, as long as the plan is operated in compliance with § 409A.

IRS Response: The Service representative indicated that there is no distinction as to when the plan was adopted. Because there is no current plan document requirement, the plan just needs to be operated in compliance with § 409A right now. The non-compliant plan terms should be ignored through the end of 2008 and the plan should be brought into compliance on January 1.

35. § 409A – Earnings on Deferred Compensation and Short-Term Deferrals

If dividend equivalents are payable on vested restricted stock units ("RSUs") that constitute deferred compensation under § 409A, can the dividend equivalents qualify as short-term deferrals pursuant to Treas. Reg. § 1.409A-1(b)(4) (such as by providing that the employee is to be paid the dividend equivalents on each dividend payment date but only if the employee is employed on the dividend payment date), or do the dividend equivalents take on the § 409A deferred compensation character of the RSUs because they are earnings on the RSUs, notwithstanding that each dividend equivalent payment is contingent on continued employment?

Proposed Response: The dividend equivalents can qualify as short-term deferrals, even if the related restricted stock units cannot.

IRS Response: The dividend equivalents can qualify as short-term deferrals if they otherwise meet the requirements for the short-term deferral exception.

36. § 409A – Short-Term Deferrals and Six Month Delay for Specified Employees

If a plan provides that § 409A deferred compensation payments to specified employees on separation from service are delayed for 6 months, does that make payments that would be short-term deferrals in the absence of that provision § 409A deferred compensation payments, because they may be paid outside the short-term deferral period on account of that provision? Even if you limit the provision to payments that are § 409A deferred compensation, does the fact that that provision is contingently applicable to the short-term deferrals disqualify them as short-term deferrals, because there is some theoretical scenario under which they might not be paid within the short-term deferral period?

Proposed Response: The 6 month delay in payments to specified employees required by Treas. Reg. § 1.409A-1(c)(3)(v) applies only to payments that constitute deferred compensation under § 409A. Payments that qualify as short-term deferrals pursuant to Treas. Reg. § 1.409A-1(b)(4) do not constitute deferred compensation under § 409A. Because the 6 month delay is inapplicable to short-term deferrals, short-term deferrals should continue to qualify as such whether or not the 6-month delay language is present in the plan.

IRS Response: If the plan provision is drafted to apply to amounts that already are deferred compensation, then it does not taint amounts that are not deferred compensation. If the plan provision states that it applies to all amounts payable on separation from service under the plan, then it is a plan term that the IRS would look at to determine whether the amounts are deferred compensation or fit within the short-term deferral exception. In other words, if the 6 month delay only applies to amounts that are already deferred compensation, the IRS will look first to whether the amounts are deferred compensation.

37. § 409A – Plan Aggregation Rules and One Time and Form of Payment Rule

If an involuntary separation pay plan provides that part of the employee's severance benefit is that the employee receives two additional years of service credit under the company's SERP (a defined benefit plan), are the incremental SERP benefits the employee earns during that 2-year period part of a nonaccount balance plan, or are they considered part of the involuntary separation pay plan such that they have to be paid at the same time and in the same form as the severance benefits?

Proposed Response: If the additional years of service credit under the company's SERP are only credited in the event of an involuntary separation from service, the resulting benefits are considered part of the involuntary separation pay plan for purposes of the plan aggregation rules set forth in Treas. Reg. § 1.409A-1(c)(2)(i)(D). However, for purposes of the "one time and form of payment" rule set forth in Treas. Reg. § 1.409A-3(c), the incremental SERP benefits are considered a different "bucket of money" from the severance benefits and need not be paid at the same time and in the same form as the severance benefits. Likewise, they are considered a different "bucket of money" from the regular SERP benefits (*i.e.*, benefits that are not credited only in the event of involuntary separation from service), and they need not be paid at the same time and in the same form as those regular SERP benefits. Thus, the "one time and form of payment" rule will be satisfied whether the incremental SERP benefits that are earned only in the event of involuntary separation from service are structured to pay out at the same time and in the same form as the regular SERP benefits, or at the same time and in the same form as the severance benefits, or at another time and in another form.

IRS Response: The Service representative generally agrees with the proposed response. This is a separately identified amount that a participant will receive only if the participant is involuntarily terminated, so it falls into the involuntary separation from service "bucket of money." Amounts that are in the same bucket may be paid differently if they are sufficiently identified in different ways, meaning this amount may be paid differently than the rest of the separation from service benefits. Whether this complies with § 409A depends on whether the SERP complies with § 409A. Presumably, if the benefits are being paid in the same way as the SERP and the SERP complies with § 409A, then this would comply with § 409A. It is treated like any other benefit, meaning it must have a set time and form of payment and any changes to that time and form of payment must comply with the anti-acceleration provisions in the subsequent deferral rules.

38. § 409A – Payment upon the "Earliest of" Rule

A SERP provides for benefits to be paid upon the earliest of separation from service, death or § 409A Disability. The Disability provision provides that, in the event of a § 409A Disability, benefits are paid at normal retirement date, and until that time the disabled employee receives additional service credit for benefits. Assuming that a § 409A separation from service occurs at some point after § 409A Disability occurs and before normal retirement date (when Disability benefits commence), does the plan satisfy the Treas. Reg. § 1.409A-3(b) that only permits payment to be made upon the earliest of the § 409A payment events?

Proposed Response: Yes. Disability is the first § 409A triggering event to occur and thus the regulation is satisfied if the time and form of payment is determined pursuant to the Disability provisions of the SERP. The Regulation requires only that the time and form of payment specified for the first of the § 409A triggering events to occur must govern. It does not require that the time of payment for the triggering event that first occurs (Disability in the example above) precede the time at which the later triggering events (separation from service or death) occur.

IRS Response: The Service representative agrees with the proposed response, provided the plan's definition of "normal retirement date" is a qualifying definition, *i.e.*, it meets the requirements of Treas. Reg. § 1.409A-3(c).

39. § 409A – One Time and Form of Payment Rule

Each year a company grants each of its executives restricted stock units. Under the aggregation rules each participant's RSUs are considered one plan. Treas. Reg. § 1.409A-3(c) provides that only one time and form of payment for each payment event is permitted, with certain limited exceptions not relevant here. Must all of the RSUs have the same time and form of payment for separation from service, or is it permissible for each grant to have a different time and form of payment for separation from service?

Proposed Response: Each grant may have a different time and form of payment for separation from service. The requirement that there be only one time and form of payment for any § 409A payment event applies only to any particular deferred compensation amount. There can be different times and forms of payment for different components of deferred compensation so long as, for each component, there is only one time and form of payment for any § 409A payment event. Each separate RSU grant represents a separate deferred compensation right that can have its own time and form of payment which can differ from the time and form of payment under other separate RSUs.

IRS Response: The Service representative generally agrees with the proposed response. The one time and form of payment rule applies to each designated amount under the plan. A plan can have multiple objectively determinable amounts under the same plan. For instance, if the plan has different accounts, the different accounts may be paid at different times if the accounts are objectively determinable accounts. If these were different restricted stock unit grants covered by § 409A and payable at separation from service, they could all have different schedules as long as the designation of that schedule otherwise met the initial deferral election rules and any changes to it met the rules. The grants can have different times and forms of payment because they would be separately identified amounts even though they are under the same plan.

40. § 409A – One Time and Form of Payment Rule

Company pays benefits in a lump sum on separation from service and in installments if employee is disabled more than 1-year. The company's policy is to terminate employment 1-year after disability, so the installment form of payment arguably could be both a § 409A disability event and a separation from service event. Treas. Reg. § 1.409A-3(c) does not allow different forms of payment for different separations from service, except in limited circumstances not present here. Does the plan violate § 409A because it provides more than one form of payment on separation from service?

Proposed Response: The plan does not fail to comply with § 409A. If the separation from service is determined to be on account of disability, the disability form of distribution will apply. If the termination is determined to be as a result of a regular separation, the regular separation benefits will apply. As a precaution, the plan can provide that when two events exist simultaneously, one form will be controlling (such as the participant's election).

IRS Response: The statute permits disability to be a separate payment event. If the payment will be made upon disability and the schedule is based on when the participant becomes disabled, regardless of whether the participant separates from service, it is a disability distribution. It should not be a problem if the disability distribution is different from the separation from service distribution because the plan will pay the disability distribution as scheduled, regardless of whether the participant is separated. If the Company retains the option to put the participant on leave and not separate him and the Company still pays the participant under the terms of the plan, it is a disability payment. If the Company requires the participant to separate from service (*i.e.*, no longer be treated as an employee) to receive the payment, then the payment may not be made in a different manner. In other words, if the payment is due solely disability, it is a disability definition. If the participant is required to separate from service and no longer be treated as an employee, it is actually a separation from service distribution which cannot be paid differently than other distributions on separation from service.

41. § 409A – One Time and Form of Payment Rule

Is it permissible for a pension plan to provide one default form of payment for married participants (*e.g.*, joint and survivor annuity) and another form of payment for unmarried participants (*e.g.*, lump sum)? Is that more than one form of payment per event? Is it a late election if a participant is married when he enters the plan but is single when payments commence?

Proposed Response: Treas. Reg. § 1.409A-3(c) does not permit a joint and survivor annuity to be paid if a participant is married but a lump sum to be paid if the participant is single because this would mean that there is more than one possible payment form for the same § 409A payment event. The Final Regulations do not provide an exception from the "one form of payment per event" rule based on marital status. Since marriage is not something one would be expected to enter into or dissolve in order to change the form of payment of deferred compensation, an exception to the "one form of payment per event" rule should be recognized for different marital status. A change in the payment form that results from a change in marital status also should not be considered an election. It should be noted that an issue would not arise under the Final Regulations if the payment form for the single participant in this question were a single life annuity (or another life annuity form) because, under the Final Regulations, a change made before the benefit commencement date from one type of life annuity to another type of life annuity that is actuarially equivalent and has the same benefit commencement date is not considered a change in the time and form of payment.

IRS Response: The Service representative disagrees with the proposed response. The final regulations do not have an exception for marital status. Different annuities may be treated as one time and form of payment, meaning a plan may offer different annuities and permit a participant to choose among the different annuities. A change among the annuity options is not treated as a change in time and form of payment, provided the commencement of payments under the annuity does not change. It is permissible to offer married versus not married participants a choice among annuities, but it is not permissible to provide a lump sum based on marital status.

42. § 409A – Payments Pursuant to a Fixed Schedule

Can a stream of payments that is not fixed, but, *e.g.*, that is made as long as the employee remains disabled, ever be § 409A compliant? Treas. Reg. § 1.409A-3(i)(1)(i) states that the schedule must be "fixed" at the time the payment event is designated. It also states that a fixed schedule must provide for objectively determinable amounts to be payable at a date or dates that are nondiscretionary and objectively determinable *at the time the amount is deferred.*

Proposed Response: As long as the maximum duration of the payment stream is specified in a nondiscretionary and objectively determinable manner (*e.g.*, until age 65 or until the death of the employee) at the time the amount is deferred, the fact that the employee's right to some of the payments may be forfeited before the maximum duration is attained due to an objective, nondiscretionary event (such as abatement of the Disability) does not prevent the payment schedule from being considered a fixed schedule under the Final Regulations.

IRS Response: The Service representative considers this analogous to a stream of payments ceasing if the participant gets another job. As long as the time and form of payment does not change, the Service representative views this as a forfeiture if the participant recovers from the disability, rather than any type of change in time or form of payment. The Service representative thinks this could still be a fixed schedule if the participant forfeits payments if he recovers from the disability.

43. § 410(b) – Qualified Automatic Contribution Arrangements

A profit sharing plan that includes immediate eligibility for the CODA and requires attainment of one year of service and age 21 for a matching contribution treats the plan as two separate plans under § 410(b) of the Code, one for employees who have completed the minimum age and service eligibility conditions under § 410(a)(1) of the Code and the other for employees who have not completed the conditions. The plan provides that it will satisfy the Code § 401(k)(13) safe harbor requirements with respect to the employees who have met the minimum age and service conditions and that it will meet the ADP test requirements with respect to the employees who have not met the minimum age and service conditions. These facts are the same as Example 2 under Treas. Reg. § 1.401(k)-1(b)(4)(vi).

Final Treas. Reg. § 1.401(k)-3(h)(3) notes that the early participation rule of Code § 401(k)(3)(F) does not apply to a cash or deferred safe harbor arrangement under Code § 401(k)(12). Prop. Treas. Reg. § 1.401(k)-3(h)(3) notes that the early participation rule of Code § 401(k)(3)(F) also does not apply to a Qualified Automatic Contribution Arrangement under Code § 401(k)(13). However, the Proposed Regulations do not modify the third sentence of Treas. Reg. § 1.401(k)-3(h)(3) in the Final Regulations which states with respect to the permissive disaggregation rules of Code § 410(b)(4)(B):

> However, a plan is permitted to apply the rules of § 410(b)(4)(B) to treat the plan as two separate plans for purposes of § 410(b) and apply the safe harbor requirements of this section to one plan and apply the requirements of § 1.401(k)-2 to the other plan. *See* § 1.401(k)-1(b)(4)(vi), Example 2.

Does the application of the permissive disaggregation rules of Code § 410(b)(4)(B) apply such that the Qualified Automatic Contribution Arrangement is only applicable to those employees who have met the minimum age and service conditions and the ADP test shall apply to those employees who have not met the minimum age and service conditions?

Proposed Response: If the plan applies the rules of Code § 410(b)(4)(B) to treat the plan as two separate plans for purposes of Code § 410(b), then the plan can apply the Code § 401(k)(13) safe harbor requirements to those employees who have met the minimum age and service conditions under Code § 410(a)(1) and apply the ADP test requirements with respect to those employees who have not met the minimum age and service conditions. Since an employee is not eligible to participate in the Qualified Automatic Contribution Arrangement until they have satisfied the minimum age and service conditions, the Automatic Deferral requirement in Code § 401(k)(13)(C) and the Matching or Nonelective Contribution requirement in Code § 401(k)(13)(D) do not apply until the employee satisfies the minimum age and service conditions.

IRS Response: The Service representative generally agrees, but cautions about the maximum entry date question that the Service is presently considering.

44. § 411 – Transfers Between Defined Contribution Plans

Employees who are leased to a recipient company participate in the recipient's money purchase pension plan. The recipient amends its money purchase pension plan to exclude the leased employees from future contributions. At the same time, the leasing organization amends its money purchase pension plan to include the leased employees. Can the leased employees make an elective transfer from the recipient's plan to the leasing organization's plan?

Proposed Response: Yes. Treas. Reg. § 1.411(d)-4, Q&A-3 permits elective transfers between defined contribution plans in connection with a participant's change in employment status to an employment status with respect to which the participant is not entitled to additional allocations under the transferor's plan. Because the leased employees are no longer entitled to additional allocations under the recipient's plan, they should be permitted to voluntarily transfer their benefit from the recipient's plan to the leasing organization's plan.

IRS Response: The Service representative agrees with the proposed response. The Service representative also cautioned that in making these transfers, the regulations must be followed including the election and notice requirements of Treas. Reg. § 1.411(d)-4, Q&A-3.

45. § 411(a) – Vesting of Normal Retirement Benefit

Section 411(a) of the Code requires a participant's "normal retirement benefit" to fully vest at or before his "normal retirement age." If a participant terminates employment with the plan sponsor before reaching his normal retirement age, at a time when his accrued benefit is 50% vested, and elects to leave his accrued benefit in the plan until he reaches his normal retirement age, will the accrued benefit become 100% vested at that time?

Proposed Response: No. The requirement in § 411(a) of the Code that a participant's accrued benefit must fully vest when the participant reaches the plan's normal retirement age applies only if the participant is still employed by the plan sponsor at that time.

IRS Response: The Service representative clarified the proposed response. A participant's accrued benefit must fully vest when the participant reaches the plan's normal retirement age if the participant is still employed by anyone in the controlled group, not just the plan sponsor.

46. § 411(b) – Benefit Accrual

May a defined benefit plan offset post-NRA benefit accruals with credited actuarial adjustments where the plan does not provide for such offset? Does it make a difference if the Plan includes a valid suspension of benefits rule but fails to comply with the notice requirement?

Proposed Response: No. Section 411(b)(1)(H)(i) provides that "a defined benefit plan shall be treated as not satisfying the requirements of this paragraph if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age." Subparagraph (iii) of that section states that "in the case of any employee who . . . has attained normal retirement age. . . – . . . (II) if distribution of benefits . . . with respect to such employee has not commenced as of the end of such year in accordance with § 401(a)(14)(C), and the payment of benefits under such plan . . . is not suspended during such plan year pursuant to [§ 411(a)(3)(B)], then any requirement of this subparagraph for continued accrual of benefits under such plan with respect to such employee during such plan year shall be treated as satisfied to the extent of any adjustment in the benefit payable under the plan during such plan year attributable to the delay in the distribution of benefits after the attainment of normal retirement age."

Although offsetting post-normal retirement age accruals with actuarial increases does not violate § 411(b)(1)(H), such offset must be provided by the plan document. In other words, § 411(b)(1)(H)(i) simply allows a plan to provide, without violating the age-discrimination restrictions in that section, that post-NRA benefit accruals may be offset by actuarial adjustments which are credited on account of a deferred benefit commencement. Without language in the plan providing for such offset, a participant's post-NRA benefit accruals may not be offset, as there is no basis in the plan document for doing so. The kind of employer discretion that would necessarily be given to employers if the plan document was not required to provide for the offset (if accruals are to be offset) is inconsistent with the fundamental requirement in § 1.401-1(b)(1) that benefits be definitely determinable.

Furthermore, whether actuarial adjustments are credited to a participant's account pursuant to a plan provision or as a result of non-compliance with the Code's and ERISA's rules governing suspension of benefits is irrelevant for purposes of determining whether the plan document must provide that post-normal retirement benefits are offset by credited actuarial adjustments. Therefore, whether the actuarial increase results from a failure to timely furnish a suspension notice or is credited in accordance with a plan term providing for the actuarial increase due to the delay in commencement makes no difference for purposes of determining whether benefit accruals may be offset by actuarial adjustments without a plan provision that so specifies.

The language in Prop. Treas. Reg. § 1.411(b)-2(b)(4)(i) is consistent with this interpretation. It states:

> *(4) Certain adjustments for benefit distributions.* (i) In general. Under § 411(b)(1)(H)(iii)(I), a defined benefit <u>plan may provide</u> that the requirement for continued benefit accrual under § 411(b)(1)(H)(i) and this paragraph (b) for a plan year is treated as satisfied to the extent of the actuarial equivalent of benefits distributed, as provided in this paragraph (b)(4). Distributions made before the participant attains normal retirement age or during a period that is not "section 203(a)(3)(B) service," as defined in 29 CFR 2530.203-3(c) of the regulations of the Department of Labor, may not be taken into account under this paragraph (b)(4). (Emphasis added).

IRS Response: The plan cannot offset post normal retirement benefit accruals with credited actuarial adjustments where the plan does not provide for such offset. The plan must be administered in accordance with its terms. If the plan does not contain an offset, it cannot use an offset. The offset may be added for future accruals, but it will be subject to § 411(d)(6).

47. § 415(c) – Inclusion of Compensation Earned by Nonresident Aliens in Definition of Compensation

Treas. Reg. § 1.415(c)-2(g)(5) allows certain compensation earned by nonresident aliens who do not participate in the plan to be disregarded if the plan so provides. Does this option apply to the safe harbors for compensation subject to income tax withholding and reporting in Treas. Reg. § 1.415(c)-2(d)(3) and (4), respectively, even though the rule states that it applies "for purposes of [Treas. Reg. § 1.415-2](b)(1) and (b)(2)"?

Proposed Response: No.

IRS Response: The Service representative agrees with the proposed response, but notes that generally, subject to certain possible exceptions, the compensation described in Treas. Reg. § 1.415-2(g)(5)(ii) (payments to nonresident aliens that are excludible from gross income and not effectively connected with the conduct of a trade or business in the United States) would not be included anyway under the safe harbors described in Treas. Reg. § 1.415-2(d)(3) and (4).

48. § 415(c) – Inclusion of all Deferrals Under Nonqualified Deferred Compensation in Definition of Compensation

Are *all* deferrals under nonqualified deferred compensation plans now required to be included in the safe harbor for compensation subject to reporting under Code § 6041 etc. in Treas. Reg. § 1.415(c)-2(d)(4), because the American Jobs Creation Act of 2004 amended § 6041 and § 6051 of the Code to require that an employer or payer report all deferrals for the year under a nonqualified deferred compensation plan on a Form W-2? If so, does the transition rule in Notice 2007-89 prevent this from happening until further notice?

Proposed Response: No. The safe harbor for compensation subject to reporting under Code § 6041 etc. in Treas. Reg. § 1.415(c)-2(d)(4) is intended to include, and does include, only amounts required to be reported in Box 1 of the Form W-2, not amounts reported in any other box of the Form W-2 or on any other form.

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

49. § 417 – Qualified Optional Survivor Annuities

If an affected pension plan provides the mandatory 50% QJSA <u>and</u> an optional annuity form that provides for a 100% survivor annuity, does the change to § 417 of the Code by the Pension Protection Act mean that the plan must now add a second qualified optional survivor annuity that provides the survivor with 75% of the participant's benefit following the participant's death?

Proposed Response: No. It is sufficient to provide the mandatory 50% QJSA and an optional 100% survivor annuity.

IRS Response: The Service representative disagrees with the proposed response. There is a requirement to have essentially a 75% joint and survivor annuity in this context. The rationale behind this is that participants were not electing the 100% joint and survivor annuity because the actuarial charge was so steep. By providing a more moderate level of spousal protection and a more moderate level of charge, it is more likely to be elected.