Current Developments in Employee Benefits and Pensions (Part I)

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This two-part article provides an overview of current developments in employee benefits, including executive compensation, health and welfare benefits, and qualified plans. Part I, below, focuses on new guidance regarding executive compensation and health and welfare benefits. Part II, to be published in the December 2009 issue, will cover new legislation and guidance for qualified retirement plans.

Sec. 409A

Though Sec. 409A was signed into law in 2004,[1] the IRS continues to issue guidance to help facilitate compliance with the new nonqualified deferred compensation (NQDC) rules. Over the past year, the IRS has released several noteworthy pieces of guidance, including proposed regulations on income inclusion. The IRS also issued rules on income timing under Sec. 457A, and legislation made a number of changes to the definition of "dependent" for benefit plans.

Sec. 409A Prop. Regs. Address Income Inclusion

On December 5, 2008, Treasury and the IRS issued proposed regulations addressing the calculation of amounts includible in income and additional taxes imposed under Sec. 409A(a).[2] The regulations are proposed to be generally applicable for tax years beginning on or after the issuance of the final regulations. Taxpayers may rely on these proposed regulations only to the extent permitted in Notice 2008-115.[3] That notice permits taxpayers to rely on the provisions of the proposed regulations that address the calculation of the amount includible in income under Sec. 409A(a) and the calculation of the additional taxes under Sec. 409A, at least until Treasury and the IRS issue further guidance.

These proposed regulations do not address the calculation of income inclusion for violations of Sec. 409A(b) requirements (the rules relating to offshore funding of NQDC plans). Treasury and the IRS anticipate issuing interim guidance under these rules for tax years beginning after January 1, 2007, as well as the application of federal income tax withholding requirements to such amounts.

Year-by-year approach: Sec. 409A generally provides that amounts deferred under an NQDC plan are includible in income unless certain requirements

1 American Jobs Creation Act of 2004, P.L. 108-357, §885.

2 REG-148326-05.

3 Notice 2008-115, 2008-2 C.B. 1367.

are satisfied. The proposed regulations interpret this rule to provide that failures to comply with Sec. 409A(a) apply to amounts deferred under a plan in the year in which the failure occurs and all previous tax years, to the extent such amounts are not subject to a substantial risk of forfeiture and have not previously been included in income.

As a result, each tax year is analyzed independently to determine whether there is a failure. Income associated with the noncompliant deferred compensation is included in income in the year in which the failure occurred and each year thereafter. However, a failure in one year does not continue to taint amounts deferred under the plan in a subsequent year in which there is no failure. The proposed regulations do not provide taxpayers with a mechanism for current inclusion of income related to a failure from a prior year.

Determination of amount deferred: Under the proposed regulations, the amount of income includible for failure to satisfy Sec. 409A(a) is the total amount deferred under the plan for the service provider's tax year and all preceding tax years, less the portion of the total amount deferred for the tax year that either is unvested or has previously been included in income as of the last day of the service provider's year. Because the determination is made on the last day of the year, the timing of actions during the year does not matter under the proposed regulations. It is not relevant whether a distribution is made prior to the occurrence of the operational failure or whether an amount was deferred under the plan after the occurrence of an operational failure. In calculating these amounts, the plan aggregation rules apply. In addition, any payments of deferred amounts to, or on behalf of, the service provider during that tax year are added back to the total amount deferred. Notional earnings or losses and additional amounts deferred during the year are simply netted against one another in determining the value as of the last day of the tax year.

In the case of a defined benefit–type plan, the amount deferred is the present value of future payments to which the service provider has a legally binding right as of that date, less the unvested amounts and amounts previously included in income.

Generally, the present value is determined using reasonable actuarial assumptions and methods. If the IRS determines that the assumption or method used is not reasonable, the applicable federal rate (based on annual compounding for the last month of the tax year for which the income inclusion amount is being determined) and, if applicable, the appropriate Sec. 417(e) mortality table are used. The regulations also provide general rules for determining the present value of payments for payment triggers based on events, alternative times and forms of payment, formula amounts, and payment restrictions.

Calculating unvested amounts and amounts previously included in income: The unvested portion of the total amount deferred for a tax year is determined as of the last day of the tax year, and such amounts are not taken into account in the calculation of the total amount deferred. Amounts that vest during the year in which the failure occurred are treated as vested for purposes of Sec. 409A(a), regardless of whether vesting occurs before or after the failure, and thus are taken into account in the calculation.

Amounts that have previously been included in income are excluded from the total amount deferred. Consistent with the overall approach of analyzing each year independently, the proposed regulations provide that amounts are considered previously included in income only if the service provider included the amount in income under an applicable provision of the Code for a previous tax year, including on an original or amended return, or as a result of IRS examination or a final decision of a court of competent jurisdiction. The amount previously included in income is reduced to reflect any payments made during the tax year because these amounts also reduce the total amount deferred after the year of distribution. Other adjustments are also provided.

For failures that occur in multiple years, each year is analyzed independently to determine if amounts were includible in income. As a result, amounts must be included in income for each year in which

EXECUTIVE SUMMARY

- The IRS issued proposed regulations on the calculation of amounts includible in income and additional taxes imposed under Sec. 409A(a). Under the proposed regulations, failures to comply with Sec. 409A(a) apply to amounts deferred under a plan in the year of failure and all previous tax years, to the extent such amounts are not subject to substantial risk of forfeiture and have not previously been included in income.
- Notice 2008-113 provides relief to taxpayers for certain inadvertent and unintentional failures in the operation of a plan that otherwise complies with Sec. 409A.
- In Rev. Rul. 2008-13, the IRS took a new position on the performance-based compensation exception to Sec. 162(m), which disallows a public company's deduction for compensation in excess of $1 million to certain executives. The ruling states that compensation will not be considered performance based if payment can be triggered without regard to whether the performance goals are met when an employee is terminated without cause, terminates employment for good reason, or retires.

a failure occurs. A failure that occurs in multiple years is not corrected if amounts are included in income only for the last year in which the failure occurred.

Determination of additional 20% and premium interest taxes: The amount includible in income is the difference between the total amount deferred less the sum of the unvested amounts and amounts previously included in income. In addition, this amount is subject to the additional 20% and premium interest taxes. The additional 20% and premium interest taxes are additional income taxes, subject to the rules governing assessment, collection, and payment of income tax. They are not excise taxes, and the premium interest tax is not interest.

The proposed regulations provide guidance on how to calculate the premium interest tax. That tax is applied to the amounts required to be included in income under Sec. 409A(a) for the tax year that were not first subject to a substantial risk of forfeiture in a previous year. The premium interest tax is determined as the amount of interest at the underpayment rate (established under Sec. 6621) plus 1% on the underpayment of tax that would have occurred had the deferred compensation been includible in gross income for the tax year in which the amounts were first deferred or vested. The proposed regulations provide step-by-step calculations to determine premium interest; the calculations tend to reduce the amount subject to the premium interest tax.

Treatment of payments and forfeitures after amounts are included in income: The proposed regulations state that if a service provider includes an amount in income under Sec. 409A, the service provider will have a deemed basis in that amount, so the amount is not later subject to tax. As a result, if an amount under a plan would be includible in income under a Code section other than Sec. 409A, the amount previously included in income under Sec. 409A would offset the taxable amount paid under the plan. The service provider cannot elect the extent to which amounts previously included in income will be applied. Earnings on amounts included in income and previously included amounts may continue to be subject to Sec. 409A. Again, the Sec. 409A plan aggregation rules apply.

If a service provider has included deferred amounts in income under Sec. 409A but actually receives less than the amount included in income, the provider may take a deduction equal to the amount included in income, less amounts allocated to previously included amounts. This deduction is a miscellaneous itemized deduction subject to the 2% floor and is not deductible for the alternative minimum tax.

For these purposes, a deferred amount is treated as permanently lost if the service provider's right to payment becomes wholly worthless during the tax year. A mere diminution in the deferred amount due to investment loss, actuarial reduction, or other decreases in the deferred amount is not treated as a permanent forfeiture or loss if the service provider retains the right to an amount deferred under the plan. If a service provider is entitled to a deduction, to the extent the service recipient has benefited from a deduction as a result of the inclusion in the service provider's income, the service recipient may be required to recognize income under the tax benefit rule of Sec. 111 or make other appropriate adjustments.

Reporting and Wage Withholding Under Sec. 409A

On December 10, 2008, the IRS released Notice 2008-115,[4] interim guidance on the reporting and wage withholding requirements for NQDC under Sec. 409A, effective for calendar year 2008 and all subsequent calendar years until Treasury and the IRS issue further guidance.

Employer reporting and withholding provisions: Under Notice 2008-115, code Y reporting in box 12 of Form W-2, Wage and Tax Statement, and box 15a of Form 1099-MISC, Miscellaneous Income, is not required for 2008 or any future year until further notice.

In general, the amount includible in gross income under Sec. 409A(a) and required to be reported on Form W-2 in boxes 1 and 12 using code Z or on Form 1099-MISC in boxes 7 and 15b equals the total amount deferred under the plan that, as of December 31 of the applicable calendar year, is not subject to a substantial risk of forfeiture and has not been included in income in a previous year, plus any amounts of deferred compensation paid or made available to the service provider under the plan during the applicable calendar year.

The notice provides specific guidance for account balance plans, reasonable ascertainable amounts under nonaccount balance plans, and stock rights. For other deferred amounts, the employer must apply a reasonable, good-faith method in a reasonable, good-faith manner.

While an employer is required to withhold income and pay employment taxes on noncompliant nonqualified deferred compensation, an employer is not required to withhold the additional income taxes associated with noncompliant nonqualified deferred compensation.

Service provider requirements for amounts includible in gross income: The standards that apply to a service recipient apply to the service provider when calculating the amount required to be reported as income under Sec. 409A, except that an amount is treated as previously included in income only if the amount has been included in the service provider's income in a previous tax year (regardless of whether it was reported on a Form W-2 or Form 1099-MISC). Whether a service provider has complied with the Notice 2008-115 requirements is determined independently of whether the service recipient has complied with those requirements. Thus, the IRS may assert additional income taxes and penalties under Secs. 6651, 6654, and 6662 if it determines that the taxpayer underreported or underpaid the amount of taxes reported and paid for a calendar year.

Limited Relief for Certain Sec. 409A Operational Failures

On December 5, 2008, the IRS issued Notice 2008-113,[5] providing relief for certain operational failures for periods

4 Notice 2008-115, 2008-2 C.B. 1367.

5 Notice 2008-113, 2008-2 C.B. 1305.

beginning on or after January 1, 2009, replacing Notice 2007-100.[6] The notice addresses eligibility and types of failures for which correction may be made, either during the same, subsequent, or second tax year after the year in which the failure occurred. It applies only to inadvertent and unintentional failures in the operation of a plan that otherwise complies with Sec. 409A. In addition, the service recipient must take commercially reasonable steps to avoid recurrence of the failure. As a result, if the same or a substantially similar failure has happened before, relief is available for tax years beginning after December 31, 2009, only if the service recipient can demonstrate that it had taken steps to ensure that the failure would not recur and that the failure occurred despite such efforts.

In order to correct a failure in a year after the year in which the failure occurred, the service provider must not be under examination with respect to the plan. Some corrections are not permitted during years in which the service recipient experiences a substantial financial downturn or there is other indication of a significant risk that the service recipient would not be able to pay the amount deferred when due. The ability to correct and the correction method depend on whether the service provider is an "insider," which is defined as a director, officer, or 10% owner of a publicly traded corporation, and similar persons of nonpublic service recipients.

Notice 2008-113 requires service recipients to attach a statement to their tax return explaining their reliance on the notice and to provide information to affected service providers (other than for correcting discounted options and stock appreciation rights). In many cases, service providers are required to attach this information to their federal income tax returns.

The amount of time between failure and correction, the status of the service provider as an insider, and the amount involved will determine the extent to which correction is available; whether income inclusion, withholding, and reporting are required; and the specific income amount required to be recognized.

If the taxpayer meets all of the foregoing eligibility requirements, the following corrections are available for the specified operational failure:

Early payments and failed deferrals: Early payments are amounts deferred in a prior year that should be paid in a future year but are mistakenly paid or made available during the current year, excluding payments that fail to comply with the six-month delay rule for specified employees and current-year amounts that should have been deferred but were paid currently. Early payments identified in the year paid can be repaid by the end of the service provider's tax year of distribution as otherwise provided by the deferred compensation arrangement. This can be done through actual repayment, through the service recipient's retention of other amounts payable, or under a 24-month grace period, assuming financial need. Noninsiders can also make this correction in the year immediately following the year in which the failure occurred.

Failure to delay distribution of deferred compensation: A failure to delay a distribution is defined as a payment made more than 30 days prior to the distribution date as otherwise defined under the plan or the payment of an amount to a specified employee within six months after separation from service. The service provider is required to repay the early distribution, subject to an agreement that the service recipient will make the distribution as provided. If repayment is made prior to the date on which payment should have been made, the service provider must wait additional time after the correct payment date equal to the number of days it held the erroneous payment. If repayment is made subsequent to the date on which payment should have been made, the service provider must wait additional time after the original payment date equal to the number of days it held the erroneous payment. If a failure to delay relates to a payment to a noninsider, it may be corrected by repaying the entire amount by the end of the year immediately following the year in which the failure occurred.

Excess deferrals: Deferrals in excess of the amount provided for under the plan or election must be distributed by the end of the service provider's current tax year, with an adjustment made to the amount to which the service provider has a legally binding right at the end of the year (e.g., a reduction in its account balance). Excess deferrals by a noninsider are also permitted to be corrected through a distribution of the excess deferral by the end of the year immediately following the year in which the failure occurred.

Discounted stock options and stock appreciation rights: A stock option or stock appreciation right (stock right) that constitutes NQDC solely because the exercise price was erroneously set at an amount less than the fair market value (FMV) of the underlying stock on the date of grant can be corrected. During the year of grant and prior to exercise of the right, the exercise price may be reset to an amount not less than the FMV on the date of grant. This correction, which can also apply to insiders, can be made to outstanding stock rights even if other rights

6 Notice 2007-100, 2007-2 C.B. 1243.

in the same grant were already exercised and therefore ineligible for correction.

Relief for failures involving limited amounts: This relief applies only if the amount does not exceed the limit on elective deferrals for qualified plans and is available only to the extent that all steps are taken by the end of the second tax year after the service provider's tax year in which the failure occurred. It applies only to early payment, failed deferrals, failure to delay distributions, and excess deferrals.

Relief for certain other operational failures: Notice 2008-113 provides further relief by limiting the extent to which the additional taxes apply for early payments and failed deferrals, failure to delay distributions, and excess deferrals regardless of the amount if correction is made by the end of the second tax year after the tax year in which the failure occurs.

Special transition relief for noninsiders: In general, operational failures that occurred prior to December 31, 2007, if otherwise eligible for correction under the methodologies discussed above for correction in the year after the year in which the failure occurred (other than discounted stock rights), are eligible for correction notwithstanding the fact that the time limit for correction has passed. For this purpose, the service provider's tax year ending in 2009 is deemed to be the year following the year in which the failure occurred.

IRS's No-Rule Policy on Sec. 409A Issues

In Rev. Proc. 2008-61,[7] the IRS modified its no-rule policy for arrangements described in Sec. 409A to permit rulings on very specific tax law provisions, such as estate and gift taxes and FICA, while continuing to prohibit rulings on the tax consequences of the establishment of, operation of, or participation in a Sec. 409A plan.

New NQDC Rules

Sec. 457A imposes new income timing rules on NQDC paid by tax-indifferent parties (i.e., nonqualified entities), effective for amounts deferred that are attributable to services rendered after December 31, 2008. Notice 2009-8,[8] the only published guidance released on Sec. 457A, is effective October 3, 2008. Taxpayers may rely on that notice until the IRS issues further guidance; subsequent guidance expanding the coverage of Sec. 457A will be applied prospectively only.

In general, Sec. 457A, which applies to both cash- and accrual-basis taxpayers, provides that any compensation deferred under an NQDC plan of a nonqualified entity is includible in gross income upon vesting[9] or, if the amount is not determinable, when the amount becomes determinable (in which case additional taxes apply). A nonqualified deferred compensation plan is any arrangement or agreement that provides for the deferral of compensation, as defined under Sec. 409A, except that the definition for purposes of Sec. 457A also includes equity plans other than incentive stock options, nonstatutory stock options (granted at FMV on the date of grant), and stock appreciation rights settled in service recipient stock.[10]

A tax-indifferent party or nonqualified entity is (1) any foreign corporation unless substantially all its income is effectively connected with the conduct of a trade or business in the United States or is subject to a comprehensive foreign income tax; and (2) any partnership unless substantially all its income is allocated to persons other than foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax and organizations that are tax exempt under the Code.

Generally speaking, substantially all the income of an entity means 80% of the entity's gross revenue. A corporation is subject to a comprehensive foreign income tax if the corporation is eligible for the benefits of a comprehensive income tax treaty or is resident in a country that has a comprehensive income tax. However, there are exceptions applicable to income that is not subject to tax because it is classified as nonresident or otherwise not subject to tax under the foreign income tax. For partnerships, a person is subject to a comprehensive foreign income tax with respect to an item of income if the foreign person takes such income into account on a current basis under the income tax laws of the country in which the foreign person is resident (except if it is included in income solely by reason of an antideferral regime), whether or not such income is distributed to the foreign person, and meets certain other requirements based on whether the person is a nonresident alien individual.

A service provider can be an individual, a corporation, an S corporation, a partnership, a personal service corporation, a noncorporate entity that would be a personal service corporation if it were a corporation, a qualified personal service corporation, or a noncorporate entity that would be a qualified personal service corporation if it were a corporation. Independent contractors that are excluded from coverage under Sec. 409A are also excluded under Sec. 457A.

Whether an entity is nonqualified is determined at the plan sponsor or service recipient level. An entity is considered the sponsor of an NQDC plan if it is the entity that would be entitled to a compensation deduction under U.S. federal income tax principles if the amounts were paid during the year. Sec. 457A does not apply to corporations on a controlled group basis, making the classification of service recipient more important than in prior years. Status as a nonqualified entity is determined as of the last day of the service provider's tax year.

As with corporations, whether a partnership is a nonqualified entity is determined as of the last day of the service provider's tax year. This determination

7 Rev. Proc. 2008-61, 2008-2 C.B. 934, superseded by Rev. Proc. 2009-3, 2009-1 I.R.B. 107.

8 Notice 2009-8, 2009-4 I.R.B. 347.

9 Vesting occurs once a person's rights to compensation are no longer conditioned upon the future performance of substantial services by the person. Vesting cannot depend on the occurrence of an event related to the transfer, as it can under Secs. 83 and 409A. Refraining from the performance of services will not defer vesting.

10 Note that short-term deferrals, defined under Sec. 457A as compensation that is paid not later than 12 months after the end of the service recipient's tax year during which the right to payment is first no longer subject to a substantial risk of forfeiture, are not considered deferred compensation.

is based on the allocations (or deemed allocations) of gross income by the partnership for the partnership's tax year ending with or within the service provider's tax year (special rules apply to a newly established partnership). This yearly determination of status as a nonqualified entity raises compliance difficulties because of the need to track any changes in the partnership members and allocations of income among partners.

Sec. 457A generally is effective for amounts deferred that are attributable to service performed after December 31, 2008. However, in the case of amounts deferred that are attributable to service performed prior to 2009, to the extent the amounts are not included in income in a tax year beginning before 2018, the amounts are includible in income in the later of (1) the last tax year beginning before January 1, 2018, or (2) the first tax year in which there is no substantial risk of forfeiture. Taxpayers can modify plans without violating Sec. 409A to allow for payment in the event amounts are included in income under Sec. 457A on or before December 31, 2011.

Secs. 457A and 409A may both apply to the amounts deferred under an arrangement. Inclusion in income under Sec. 457A is treated as a payment for purposes of the short-term deferral rule under Sec. 409A. But a Sec. 457A short-term deferral arrangement may nevertheless constitute NQDC for purposes of Sec. 409A and will therefore need to comply with those provisions.

Notice 2008-113 applies only to inadvertent and unintentional failures in the operation of a plan that otherwise complies with Sec. 409A.

Sec. 162(m) Performance-Based Compensation Exception

In general, Sec. 162(m) disallows a public company's deduction for compensation in excess of $1 million paid to certain executives, unless certain exceptions are met. One such exception is for performance-based compensation. The regulations are very detailed with respect to the requirements that must be met before compensation is considered performance based, including the requirement that performance-based compensation may be payable only upon attainment of the performance goals unless payment is made on account of death, disability, or change of ownership or control.[11]

The IRS extended this exception in Letter Rulings 199949014 and 200613012[12] to allow a plan or grant to include a provision permitting payment based on termination by the employer without cause, termination by the employee with good reason, or on retirement. However, the IRS reversed this position in Letter Ruling 200804004 and Rev. Rul. 2008-13.[13] As a result, a plan provision providing for payment without regard to attainment of the performance goals upon termination without cause or for good reason will cause all payments under the bonus plan to fail to qualify as Sec. 162(m)(4)(C) performance-based compensation, even for those individuals who continue in employment and otherwise satisfy the performance goals.

Rev. Rul. 2008-13, which changed the IRS's position, provided relief for certain arrangements. The ruling outlines particular fact situations that involve a publicly held corporation maintaining a bonus plan that pays cash awards to employees if the corporation's earnings per share do not decrease during the calendar year. While the plan meets the other requirements of the performance-based compensation exception, it permits payment even if the goal is not attained if (1) the employee is terminated without cause or the employee voluntarily terminates employment for good reason or (2) the employee voluntarily retires during the performance period. Given the plan's provision providing for payment in these events, compensation paid under the plan would not be qualified performance-based compensation and as a result would be subject to Sec. 162(m) disallowance.

Rev. Rul. 2008-13 provides transition relief such that a deduction will not be disallowed for any compensation that otherwise satisfies the performance-based compensation exception and that is paid under a plan, agreement, or contract that contains payment terms similar to the terms described in the revenue ruling if either (1) the performance period for such compensation begins on or before January 1, 2009, or (2) the compensation is paid pursuant to the terms of an employment contract as in effect (without respect to future renewals or extensions) on February 21, 2008.

Thus, compensation paid under an arrangement the performance period of which begins before January 2, 2009, and compensation paid under a contract in effect on February 21, 2008 (not taking into account extensions or renewals), may still permit payment upon termination without cause, voluntary termination for good reason, or voluntary retirement. Contracts that are extended, renewed, or effective after February 21, 2008, and arrangements with performance periods beginning after January 1, 2009, will need to be amended to comply with the performance-based compensation exception under Sec. 162(m) by either eliminating these payment options or ensuring that any payment on involuntary termination or retirement is only payable based on applicable performance goals.

Given the widespread reductions in force occurring in today's economic environment and the likelihood that transition relief provided by Rev. Rul. 2008-13 may be expiring for those who were able to rely on it, employers should remember to review their plans and agreements

11 Regs. Sec. 1.162-27(e)(2)(v).

12 IRS Letter Rulings 199949014 (12/13/99) and 200613012 (3/31/06).

13 IRS Letter Ruling 200804004 (1/25/08); Rev. Rul. 2008-13, 2008-1 C.B. 518.

for compliance with Rev. Rul. 2008-13. Changes may be required for the performance period beginning after January 1, 2009.

Guidance on Using Smartcards or Debit Cards for Mass Transit Benefits

The IRS has extended the effective date for its guidance on using smartcards, debit or credit cards, or other electronic media to provide certain Sec. 132(f) qualified transportation fringe benefits until January 1, 2010, to give transit systems more time to update their technologies to be compatible with certain requirements.[14]

The value of certain employer-provided qualified transportation fringe benefits is not included in employees' gross incomes for federal income tax purposes, up to specific limits,[15] and is not subject to employment taxes.[16] A "qualified transportation fringe" is transportation in a commuter highway vehicle, any transit pass, or qualified parking.

Employers generally can provide qualified transportation fringe benefits by reimbursing employees for the cost of these benefits. However, cash reimbursements for transit passes are permitted only if "a voucher or similar item that may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee." A voucher or similar item is readily available "if and only if the employer can obtain it from a voucher provider that does not impose fare media charges greater than 1% of the average annual value of the voucher for a transit system, and does not impose other restrictions causing the voucher not to be considered readily available."[17]

Cash reimbursements, when permitted, must be made under a bona fide reimbursement arrangement. Reimbursements can be made only for expenses that have already been incurred, and the employer must implement reasonable substantiation procedures. While this usually involves collecting receipts from employees, if the seller of the parking or transportation services does not provide receipts in the ordinary course of business, employers can accept employee certifications if they have no reason to doubt such certifications. Employers may not rely on employees certifying that they will incur eligible expenses in the future. There are no substantiation requirements if the employer distributes transit passes (including vouchers or similar items) in kind to employees.

Rev. Rul. 2006-57[18] describes four situations in which employers give employees smartcards or debit cards to use for mass transit fares to analyze whether the employers' methods for delivering these benefits and substantiating employees' expenses are consistent with the requirements for providing qualified transportation fringe benefits that are excluded from employees' gross incomes under Secs. 132(a)(5) and (f). While Notice 2008-74 delays the effective date of Rev. Rul. 2006-57 until January 1, 2010, employers and employees may rely on the ruling for transactions occurring before that date.

Bicycle Commuting Reimbursement

Effective January 1, 2009, expenses incurred by an employee in using a bicycle for travel between home and work can be reimbursed tax free by the employer as a qualified transportation fringe benefit. These are expenses "for the purchase of a bicycle and bicycle improvements, repair, and storage, if the employee uses the bicycle regularly for travel between his or her residence and place of employment."[19]

Reimbursements are made during the calendar year in which the expenses are incurred or within three months after the close of the year (i.e., a 15-month period). Bicycle expenses are subject to an annual maximum reimbursement amount equal to $20 multiplied by the number of qualified bicycle commuting months during the year. A "qualified bicycle commuting month" is any month during which the employee "regularly uses" the bicycle for a "substantial portion" of the travel between the employee's residence and work and does not receive any other qualified transportation fringe benefits. While the IRS has not issued guidance yet, Sec. 125 would generally prohibit a plan from being retroactively amended to provide a tax benefit.

Changes to Definition of "Dependent" for Benefit Plans

The Fostering Connections to Success and Increasing Adoptions Act of 2008[20] made a number of changes to the Sec. 152 definition of "dependent," effective for tax years beginning after December 31, 2008. The Sec. 152 dependent definition forms the basis for determining if employers can provide benefits to these individuals under the employer's health plans and other benefit plans on a tax-preferred basis and not report them on the employee's Form W-2.

A taxpayer may claim someone as a dependent for federal income tax purposes only if he or she is the taxpayer's qualifying child or qualifying relative, as defined by Sec. 152. A child can be classified as either a qualifying child or a qualifying relative. Currently, Sec. 152(c) imposes relationship, residence,

14 Notice 2008-74, 2008-38 I.R.B. 718.
15 Sec. 132(a)(5).
16 See Secs. 3121(a)(20), 3306(b)(16), and 3401(a)(19).
17 See Regs. Sec. 1.132-9(b), Q&A-16.
18 Rev. Rul. 2006-57, 2006-2 C.B. 911.
19 Sec. 132(f)(5)(F)(i).
20 Fostering Connections to Success and Increasing Adoptions Act of 2008, P.L. 110-351.

age, and support requirements in determining whether an individual is a qualifying child. In terms of the required relationship, a qualifying child is a child of the taxpayer or a descendant of such a child (or is a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of such a relative). In terms of residence, the qualifying child must have the same principal place of abode as the taxpayer for more than one-half the tax year. In terms of age, the qualifying child must be under age 19, or be a student under age 24, as of the close of the calendar year. In terms of support, the qualifying child must not have provided more than half of his or her support for the tax year.

The act amends Sec. 152(c) effective for tax years beginning after December 31, 2008, to require that the qualifying child must be younger than the taxpayer claiming the individual as a qualifying child. The qualifying child must not have filed a joint return (other than for a claim of refund) for the tax year beginning in the calendar year in which the taxpayer's tax year begins. Sec. 152(b) currently prohibits a married individual who files a joint return from being treated as a dependent under Sec. 152, although revenue rulings allow such an individual to be treated as a dependent if (1) the reason for the joint return was to obtain a refund and (2) neither the individual nor the spouse would have a tax liability if each filed separately.[21]

Where the parents are eligible to claim the individual as a qualifying child but do not, another taxpayer who is eligible to claim the individual as a qualifying child may do so if that taxpayer's adjusted gross income (AGI) is higher than the highest AGI of any parent. Sec. 152(c)(4) currently provides that if both a parent and a nonparent can claim the same individual as a qualifying child, the individual is treated as the qualifying child of the parent.

Therefore, effective in 2009, if the individual is older than the taxpayer, the taxpayer may no longer claim the individual as a qualifying child dependent, although he or she could be a qualifying relative. Also effective in 2009, a nonparent (e.g., grandparent, aunt, or uncle) may claim an individual as a qualifying child if the parents do not and the nonparent's AGI is higher than that of either parent. Beginning in 2009, a married individual who files a joint return only for a claim of refund may constitute a qualifying child if the other requirements of Sec. 152(c) are met.

Where the qualifying child requirements are not met, Sec. 152(d) provides a definition of "qualifying relative" by which the taxpayer may still claim the dependency exemption. Where the dependent individual is older than the taxpayer, the dependency exemption may still be available after 2008 if the individual's gross income is less than the exemption amount and the taxpayer provided more than half the individual's support for the year.

Self-Insured Medical Plans

IRS Technical Advice Memorandum (TAM) 200846021[22] changes an audit position and clarifies that accrual-basis employers who provide self-insured medical benefits can deduct the covered expenses in the year the medical services are provided—even if the expenses are paid more than 2½ months after the close of the year. The TAM addresses the typical scenario in which an accrual-basis employer provides self-insured medical and dental benefits to its employees without establishing a welfare benefit fund under Sec. 419(e).

In most cases, the employer pays benefits directly for covered expenses under the plan, and covered expenses are incurred when the medical service is provided. A third-party administrator reviews claims, determines eligibility, and pays benefits. Benefits are paid from a checking account funded by the employer or are paid by the administrator, who is then reimbursed by the employer. Both the checking account and reimbursements to the administrator are funded from the employer's general assets.

The third-party administrator generally pays claims within 30 days of receipt. However, delays in billing by service providers sometimes cause the administrator to make payments more than 2½ months after the tax year in which the medical services are provided. The issue addressed in the TAM is whether such expenses are deductible by the employer in the tax year in which the medical services are provided or the tax year in which the medical expenses are paid.

The IRS reasoned that Secs. 446 and 461 generally require an accrual-basis taxpayer to deduct the expenses in the tax year the services were performed. An accrual-basis taxpayer must take a liability into account in the tax year in which all the events occurred to establish "the fact and amount of the liability" and in which "economic performance" has occurred with respect to the liability. The IRS concluded that for self-insured medical expenses, both the fact and amount of the liability and the economic performance generally occur in the year the medical services are provided.

However, if the expenses are paid more than 2½ months after the end of the year in which the medical services are provided, the benefits may constitute deferred compensation under Temp. Regs. Sec. 1.404(b)-1T. In that case, Sec. 461 provides an exception to the "economic performance" rule, under which the timing of economic performance—and thereby the employer's deduction—is governed by Sec. 404. Sec. 404(a)(5) provides that the deferred compensation is deductible in the tax year in which the amount is includible in the employee's gross income (or would be includible disregarding the Sec. 105 exclusion for amounts paid for medical care expenses). Significantly, this timing rule does not apply where the employer provides welfare benefits through a welfare benefit fund under Sec. 419(e).

Employing the Sec. 404 analysis, the IRS reasoned that if a self-funded medical plan is not providing benefits through a Sec. 419(e) welfare benefit fund and payment is made more than 2½ months after the end of the tax year in which the services are provided, the employee would—disregarding the exclusion under Sec. 105—include the "deferred

21 Rev. Ruls. 65-34, 1965-1 C.B. 86, and 54-567, 1954-2 C.B. 108.

22 IRS Technical Advice Memorandum 200846021 (11/14/08).

compensation" in gross income in the year the medical services are provided. Therefore, the IRS explained that even if the payment of medical expenses more than 2½ months after the close of the tax year constitutes deferred compensation under Sec. 404, the employer could nonetheless deduct medical expenses in the year the medical services are provided.

As a result, the IRS refused to rule on whether payments made more than 2½ months after the close of the year constitute deferred compensation. Such a determination was unnecessary, it explained, since under either analysis—as deferred compensation under Sec. 404 or as an incurred liability under Sec. 461—the medical expenses would be deductible by the employer in the year the medical services were provided.

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