Part I

Section 401. - Qualified Pension, Profit-sharing, and Stock Bonus Plans

Annual Paid Time Off Contributions

Rev. Rul. 2009-31

ISSUES

(1) Do the amendments described below to an existing qualified profit-sharing plan requiring or permitting certain annual contributions of the dollar equivalent of unused paid time off cause the plan to fail to meet the requirements of § 401(a) and, if applicable, § 401(k) of the Internal Revenue Code (Code)?

(2) When is a participant required to recognize gross income with respect to the contributions to the qualified profit-sharing plan and payments to the participant as described below?

FACTS

For purposes of each situation below, it is assumed that the employer is a corporation to which subchapter C of Chapter 1, Subtitle A, of the Code applies; that each participant is an individual who accounts for gross income under the cash receipts and disbursements method of accounting and has a calendar year taxable year; that all employees of the employer are eligible to participate in the paid time off plan (the PTO Plan) on substantially the same terms and conditions; that prior to its amendment, the PTO Plan qualifies as a bona fide sick and vacation leave plan for purposes of § 409A and § 1.409A-1(a)(5) of the Income Tax Regulations; that all payments for paid time off (whether paid for used or unused time off) are made from the general assets of the employer; and that the employer has two-week pay periods. For this purpose, a paid time off plan refers to a sick and vacation leave plan under which a participant may take paid leave without regard to whether the leave is due to illness or incapacity.

<u>Situation 1</u>

Company Z maintains the Company Z PTO Plan (Z PTO Plan), under which all participants are granted up to 240 hours of paid time off each January 1 (prorated for new hires commencing employment during the calendar year), with the number of hours depending solely on the participant's number of years of service. For this purpose, salaried employees are treated as working 8 hours per work day. Under the Z PTO Plan, no unused paid time off hours remaining as of the close of business on December 31 may be carried over to the following year.

Company Z also maintains the Company Z Profit Sharing Plan (Z Profit Sharing Plan), which is a profit-sharing plan that, without regard to the amendment described in this Situation 1, meets the requirements of § 401(a). The Z Profit Sharing Plan includes a qualified cash or deferred arrangement under § 401(k) that provides for elective contributions and that does not provide for catch-up contributions under § 414(v). The Z Profit Sharing Plan has a calendar year plan year and limitation year.

In December 2008, Company Z amended the Z Profit Sharing Plan and the Z PTO Plan, effective January 1, 2009, to provide that (1) the dollar equivalent of any unused paid time off as of the close of business on December 31 is forfeited under the Z PTO Plan and the dollar equivalent of the amount forfeited is contributed to the Z Profit Sharing Plan and allocated to the participant's account as of December 31, to the extent the contribution (in combination with prior annual additions) does not exceed the applicable limitations under § 415(c), and (2) the dollar equivalent of any remaining paid time off is paid to the employee by February 28 of the following year. Under the Z Profit Sharing Plan, the amounts attributable to paid time off are in addition to other contributions under the plan and are treated as nonelective contributions. For these purposes, the dollar equivalent of the unused paid time off is determined as the number of hours of unused paid time off multiplied by the participant's hourly rate of compensation as of December 31 of that year (determined for salaried employees by treating the employee as working 8 hours per work day).

A is an employee of Company Z who participates in the Z PTO Plan and the Z Profit Sharing Plan. As of the close of business on December 31, 2009, A has 20x hours of unused paid time off and earns $25 per hour, and therefore the dollar equivalent of A's unused paid time off is $500x. Because of the application of the limitations under § 415(c), Company Z may contribute only $400x of unused paid time off to the Z Profit Sharing Plan for allocation to A's account in the 2009 limitation year (in combination with prior annual additions).

Company Z contributes $400x to the Z Profit Sharing Plan on behalf of A on February 28, 2010, and allocates this amount to A's account under the Z Profit Sharing Plan as of December 31, 2009. Company Z pays A the remaining $100x in cash on February 28, 2010.

<u>Situation 2</u>

Company Y maintains the Company Y PTO Plan (Y PTO Plan), under which participants ratably accrue up to 240 hours of paid time off each calendar year on a pay-period basis beginning on January 1 and at the end of the year may carry over to the following year an amount of unused paid time off not to exceed a specified number of hours (the carryover limit). For this purpose, salaried employees are treated as working 8 hours per work day. The dollar equivalent of any unused paid time off for a year in excess of the carryover limit is paid to the participant by February 28 of the following year.

Company Y also maintains the Company Y Section 401(k) Plan (Y 401(k) Plan), which is a profit-sharing plan that, without regard to the amendment described in this Situation 2, meets the requirements of § 401(a). The Y 401(k) Plan includes a qualified cash or deferred arrangement under § 401(k) that provides for elective contributions and that does not provide for catch-up contributions under § 414(v). The Y 401(k) Plan has a calendar year plan year and limitation year.

In December 2008, Company Y amended the Y 401(k) Plan and the Y PTO Plan, effective January 1, 2009, to provide that a participant may elect to reduce all or part of the dollar equivalent of any unused paid time off that may not be carried over to the following year and have that amount contributed by Company Y to the Y 401(k) Plan and allocated to the participant's account as of the beginning of the third pay period of the following year, to the extent that the contribution (in combination with prior annual additions) does not exceed the applicable limitations under § 415(c) and to the extent that the contributions (in combination with prior elective deferrals) do not exceed the applicable limitation under § 401(a)(30). Under the terms of the Y 401(k) Plan, contributions of the dollar equivalent of paid time off are in addition to other contributions under the Y 401(k) Plan and are treated as elective contributions (for example, the same distribution restrictions apply). The dollar equivalent of any unused paid time off that is not contributed to the Y 401(k) Plan under the terms of the amended Y PTO Plan is paid to the participant by February 28 of the following year. For these purposes, the dollar equivalent of the unused paid time off is determined as the number of hours of unused paid time off multiplied by the participant's hourly rate of compensation as of December 31 of the initial year (determined for salaried employees by treating the employee as working 8 hours per work day).

B is an employee of Company Y who participates in the Y PTO Plan and the Y 401(k) Plan. As of the close of business on December 31, 2009, B has 15x hours of unused paid time off in excess of the carryover limit and earns $30 per hour, so the dollar equivalent of B's unused paid time off in excess of the carryover limit is $450x.

Pursuant to a valid and timely election, B elects to have 60% of the dollar equivalent of the unused paid time off in excess of the carryover limit, or $270x, contributed to the Y 401(k) Plan, the contribution of which would not cause the plan to exceed the limitations under §§ 401(a)(30) and 415(c) for the applicable year. On February 1, 2010, Company Y contributes $270x to the Y 401(k) Plan and allocates $270x to B's account under the plan as of February 1, 2010.

Under the terms of the Y 401(k) Plan, this amount is treated as a contribution for the 2010 plan year. Company Y pays B the remaining $180x on February 1, 2010.

LAW

Section 401(a) provides that a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries constitutes a qualified trust under that section if a series of conditions is met. Section 401(a)(4) provides as one of those conditions that the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of § 414(q)). A plan maintained pursuant to a collective bargaining agreement is deemed to satisfy the nondiscrimination requirements. In other cases, under the regulations under § 401(a)(4), the amount of nonelective contributions under a profit-sharing plan must satisfy either a design-based safe harbor or a test based on the contributions made for individual participants.

Section 401(a)(30) of the Code provides that in the case of a trust which is part of a plan under which elective deferrals (within the meaning of § 402(g)(3)) may be made with respect to any individual during a calendar year, such trust does not constitute a qualified trust unless the plan provides that the amount of such deferrals under such plan and all other plans, contracts, or arrangements of an employer maintaining such plan may not exceed the amount of the limitation in effect under § 402(g)(1)(A) for taxable years beginning in such calendar year. Under § 402(g)(3), elective contributions under a qualified cash or deferred arrangement are included in the definition of elective deferrals.

Section 401(k)(2)(A) provides, in pertinent part, that a qualified cash or deferred arrangement is any arrangement which is part of a profit sharing plan or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan, which meets the requirements of § 401(a), and under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash.

Section 1.401(k)-1(a)(3)(i) provides that a cash or deferred election is any election by an employee to have the employer either: (A) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available or (B) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

Section 1.401(k)-6 defines nonelective contributions as employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan. Section 1.401(k)-6 defines elective contributions as contributions made pursuant to a cash or deferred election under a cash or deferred arrangement (whether or not qualified).

Under § 401(k)(3)(A)(ii), elective contributions under a qualified cash or deferred arrangement generally must satisfy the actual deferral percentage test. Section 1.401(k)-2(a)(4)(i) provides generally that for purposes of the actual deferral percentage test, elective contributions are taken into account for a year if the elective contribution is allocated to the participant's account under the plan as of a date within that year, and certain other requirements are satisfied.

Section 402(a) provides that any amount actually distributed to any distributee by an employees' trust described in § 401(a) which is exempt from tax under § 501(a) is taxable to the distributee in the taxable year of the distributee in which distributed, under § 72. Section 72(t) provides, in pertinent part, that the income tax applicable to any amount a participant receives from a qualified plan generally is increased by an amount equal to 10 percent of the portion of the amount includible in gross income unless the amounts are distributed on or after the date on which the participant attains age 59 ½ or after the participant's separation from service after attainment of age 55.

Section 402(e)(3) provides, in pertinent part, that contributions made by an employer on behalf of an employee to a trust which is part of a qualified cash or deferred arrangement (as defined in § 401(k)(2)) are not treated as distributed or made available to the employee nor as contributions made to the trust by the employee merely because the arrangement includes provisions under which the employee has an election whether the contribution will be made to the trust or received by the employee in cash.

Section 415(a)(1)(B) provides that a trust which is part of a pension, profit-sharing, or stock bonus plan shall not constitute a qualified trust under § 401(a) if in the case of a defined contribution plan, contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitation of § 415(c). Section 415(c)(1) provides that contributions and other additions with respect to a participant exceed the limitation of § 415(c) if, when expressed as an annual addition to the participant's account, the annual addition is greater than the lesser of $40,000 or 100 percent of the participant's compensation. Section 415(d)(1)(C) provides that the Secretary shall adjust annually the $40,000 amount for increases in the cost-of-living.

Section 1.415(c)-1(b)(1)(i) generally defines the term "annual addition" as the sum, credited to a participant's account for any limitation year, of (A) employer contributions; (B) employee contributions; and (C) forfeitures. Under § 1.415(c)-1(b)(6), an annual addition generally is treated as credited to the account of a participant for a particular limitation year if it is allocated to the participant's account under the terms of the plan as of any date within that limitation year.

Section 415(c)(3)(A) provides that, in general, the term "participant's compensation" means the compensation of the participant from the employer for the year. Section 1.415(c)-2(b)(1) provides that, for purposes of § 415, compensation includes amounts received for personal services actually rendered in the course of employment with the employer maintaining the plan, to the extent that the amounts are includible in gross income (or to the extent the amounts would have been received and includible in gross income but for certain elections, including an election described in § 402(e)(3)). However, under § 1.415(c)-2(b)(2), contributions by an employer to a plan of deferred compensation (other than certain elective contributions described in § 402(e)(3)) are not included in compensation for purposes of § 415.

Section 1.415(c)-2(e)(1)(i) states in pertinent part that, in order to be taken into account for a limitation year, compensation within the meaning of section 415(c)(3) must be actually paid or made available to an employee (or, if earlier, includible in the gross income of the employee) within the limitation year. Section 1.415(c)-2(e)(1)(ii) states in pertinent part that, except as otherwise provided in § 1.415(c)-2(e), in order to be taken into account for a limitation year, compensation within the meaning of section 415(c)(3) must be paid or treated as paid to the employee (in accordance with the rules of § 1.415-2(e)(1)(i)) prior to the employee's severance from employment with the employer maintaining the plan.

Section 451(a) and § 1.451-1(a) provide that an item of gross income is includible in gross income in the taxable year in which it is actually or constructively received by a taxpayer using the cash receipts and disbursements method of accounting. Under § 1.451-2(a), income is constructively received in the taxable year during which it is credited to a taxpayer's account, set apart or otherwise made available so that the taxpayer may draw on it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Section 409A(a)(1)(A)(i) provides, in pertinent part, that if at any time during a taxable year a nonqualified deferred compensation plan fails to meet certain requirements set forth under § 409A(a), or is not operated in accordance with such requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A(a)(1)(B) provides, in pertinent part, that any compensation required to be included in gross income under § 409A(a)(1)(A) for a taxable year shall be subject to the additional taxes set forth in § 409A(a)(1)(B).

Section 409A(d)(1) provides that the term "nonqualified deferred compensation plan" means any plan that provides for the deferral of compensation, other than: (A) a qualified employer plan and (B) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. Section 409A(d)(2) provides, in pertinent part, that the term "qualified employer plan" means any plan, contract, pension, account or trust described in § 219(g)(5)(A) or (B) (without regard to § 219(g)(5)(A)(iii)).
Section 219(g)(5)(A)(i) refers to a plan described in § 401(a), which includes a trust exempt from tax under § 501(a).

ANALYSIS

Situation 1

The amendment of the Z Profit Sharing Plan to require certain contributions of the dollar equivalent of unused paid time off to the Z Profit Sharing Plan does not cause the Z Profit Sharing Plan to fail to meet the requirements of § 401(a), provided that the contributions made pursuant to the arrangement satisfy the nondiscrimination requirements of § 401(a)(4) (in combination with other contributions and forfeitures allocated for the year). Because A is not provided a right to elect a payment of the dollar equivalent of the unused paid time off in lieu of a plan contribution, Company Z's contribution of $400x to the Z Profit Sharing Plan is not an elective contribution that is made pursuant to a cash or deferred election within the meaning of § 401(k)(2)(A) and § 1.401(k)-(1)(a)(3)(i). Rather, Company Z's contribution to the Z Profit Sharing Plan is a nonelective employer contribution within the meaning of § 1.401(k)-6.

The amount contributed and allocated for each participant will vary based on the amount of the participant's unused paid time off. Thus, contributions for unused paid time off are likely to preclude a plan from satisfying a design-based safe harbor under § 401(a)(4). Therefore, testing based on the contributions made for individual participants generally will be required.

The contributions made pursuant to the arrangement must also not exceed the limitations under § 415(c) (in combination with prior annual additions). Because the contribution of $400x on behalf of A was allocated to A's account as of December 31, 2009, and made February 28, 2010 (before the end of the 30 day period following the deadline for Company Z to file its income tax return), it is subject to the limitations under § 415(c) applicable for the 2009 limitation year and is taken into account for § 401(a)(4) purposes for the 2009 plan year. Under the facts presented, the contribution of $400x does not cause the plan to exceed the limitations under § 415(c).

If the requirements of § 401(a)(4) are met, the amount contributed will be includible in A's gross income in accordance with § 402(a) only when distributed to A. Like any other distribution from the Z Profit Sharing Plan, the distribution of amounts attributable to the dollar equivalent of the unused paid time off is subject to an additional 10% income tax under § 72(t) unless the distribution satisfies one of the exceptions described in § 72(t)(2), such as being made on or after the date on which the participant attains age 59½ or after the participant separates from service after attainment of age 55.

Under the Z PTO Plan as amended, the dollar equivalent of unused paid time off is not paid, set apart, or otherwise made available so that A may draw on it either (i) during the 2009 calendar year or (ii) upon conversion in 2009 to a contribution to a qualified plan or cash payment in 2010. Therefore, under the doctrine of constructive receipt and § 451, such amount is not includible in A's gross income in 2009. In addition, the amendment to the Z PTO Plan and the operation of the plan in accordance with the terms of the amendment do not cause the Z PTO Plan to fail to qualify as a bona fide sick and vacation leave plan for purposes of § 409A and § 1.409A-1(a)(5). The $100x payment is includible in A's gross income in 2010, the taxable year in which it is paid to A.

Situation 2

The amendment of the Y 401(k) Plan to permit certain contributions of the dollar equivalent of unused paid time off to the Y 401(k) Plan does not cause the Y 401(k) Plan to fail to meet the requirements of §§ 401(a) and 401(k), provided that the contributions (taking into account other contributions, prior deferrals, and prior annual additions, as applicable) satisfy the nondiscrimination requirements of § 401(k) and the applicable limitations of §§ 401(a)(30) and 415(c).

Because B is provided a right to elect either a payment of cash or a plan contribution for the dollar equivalent of unused paid time off that may not be carried over to the subsequent year, Company Y's contribution of $270x to the Y 401(k) Plan and allocation to B's account under the plan is an elective contribution. Because the contribution is made on February 1, 2010 and is not treated as allocated for 2009, it is taken into consideration for the nondiscrimination requirements of § 401(k) and the limitations of §§ 401(a)(30) and 415(c) for 2010.

Under the facts presented, the allocation of $270x would not cause the Y 401(k) Plan to exceed the limitations of § 415(c) for the 2010 limitation year. Although the dollar equivalent of the unused paid time off was made available to D in 2010, pursuant to § 402(e)(3), the $270x is not treated as made available to D if the amount was contributed to the plan as part of a qualified cash or deferred arrangement. If the requirements of §§ 401(k) and 401(a)(30) are met, the contribution will have been made pursuant to a qualified cash or deferred arrangement under § 401(k) and will be includible in B's gross income in accordance with § 402(a) only when distributed to B. Like any other distribution from the Y 401(k) Plan, the distribution of amounts attributable to the dollar equivalent of the unused paid time off is subject to an additional 10% income tax under § 72(t) unless the distribution satisfies one of the exceptions described in

§ 72(t)(2), such as being made on or after the date on which the participant attains age 59½ or after the participant separates from service after attainment of age 55.

Under the Y PTO Plan, as amended, the dollar equivalent of unused paid time off is not paid, set apart, or otherwise made available so that B may draw on it either (i) during the 2009 calendar year or (ii) upon conversion in 2009 to a contribution to a qualified plan or cash payment in 2010. Therefore, under the doctrine of constructive receipt and § 451, such amount is not includible in B's gross income in 2009. In addition, the amendment to the Y PTO Plan and the operation of the plan in accordance with the terms of the amendment do not cause the Y PTO Plan to fail to qualify as a bona fide sick and vacation leave plan for purposes of § 409A and § 1.409A-1(a)(5). The $180x payment is includible in B's gross income in 2010, the taxable year in which it is paid to B.

HOLDING

(1) Under the facts presented, the amendments requiring or permitting certain contributions of the dollar equivalent of unused paid time off to a qualified profit-sharing plan do not cause the plan to fail to meet the qualification requirements of § 401(a), provided that the contributions satisfy the applicable requirements of §§ 401(a)(4) and 415(c) and, where applicable, §§ 401(k) and 401(a)(30).

(2) Under the facts presented, assuming the applicable qualification requirements are satisfied, a participant does not include in gross income contributions of the dollar equivalent of unused paid time off to the profit-sharing plan in accordance with § 402(a) until distributions are made to the participant from the plan and does not include in gross income an amount paid for the dollar equivalent of unused paid time off that is not contributed to the profit-sharing plan until the taxable year in which the amount is paid to the participant.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Robert Gertner, Roger Kuehnle, and Alice Lynch of the Employee Plans, Tax Exempt and Government Entities Division. Questions regarding this revenue ruling may be sent via e-mail to retirementplanquestions@irs.gov.