

Required Changes to Compensation for Retirement Plan Purposes

Background

The IRS issued new regulations that affect the definition of compensation for retirement plans for plan years beginning after June 30, 2007. For a calendar year plan, the regulations are first effective for the 2008 plan year. These changes to compensation may impact contributions or benefits provided to terminated employees, including 401(k) deferrals and employer contributions.

The new regulations make it clear that some types of compensation which are paid after an employee terminates employment must be counted for plan purposes, while other types of post-termination compensation must not be counted for plan purposes.

Compensation That Must Be Counted

Types of compensation that must be counted if paid after termination of employment are:

- Regular pay,
- Overtime, and
- Commissions

Counting the following types of compensation is optional:

- Accrued vacation time,
- Accrued sick or other paid time off, and
- Payments from a nonqualified deferred compensation plan

We recommend the definition of compensation include the following types of optional compensation:

- Accrued vacation time
- Accrued sick, and other paid time off

These items are already included on the employee's Form W-2, which is the definition of compensation that most of our clients' plans use. In order for us to accurately check the compensation information that you provide we will need to request this additional information whether or not your plan's definition of compensation includes these items, therefore we are not recommending that our clients change their definition of compensation because of the new regulation.

Please note that if your plan already has specific compensation exclusions, this regulation will not change your current compensation definition for plan purposes. If you have a nonqualified deferred compensation plan and wish to include payments to terminated employees in your plan's definition of compensation, please contact your Kravitz consultant.

Timing Issues

The regulations require that compensation must be counted for plan purposes as long as it is paid within 2-1/2 months after severance from employment or, if later, the end of the plan year that includes the date of severance. Therefore, compensation that is earned but not paid until the next year must be counted for plan purposes if it is included in the plan's definition of compensation and it is paid within 2-1/2 months after severance from employment.

Compensation That Must Not Be Counted

Compensation that must not be counted is compensation paid *only* because of the employee's termination of employment. This includes compensation that was not earned during the course of the employee's regular employment and would not have been paid if the employee had not terminated, for example, true severance pay or "parachute" payments.

Impact on 401(k) Contributions and other plan contributions

Most 401(k) plans provide that a participant is permitted to make 401(k) deferrals on total compensation. Because most post-severance compensation is now considered part of total compensation, employee 401(k) contributions must be withheld from all compensation, including post-severance compensation, unless the participant makes a written election to stop 401(k) deferrals. In addition, if the employee is otherwise eligible, matching contributions, profit sharing contributions and other employer contributions must be take this post-severance compensation into account.

- *Example 1:* An employee participates in a 401(k) plan and defers 10% of his compensation into the 401(k) plan per paycheck. The plan uses the calendar year as the plan year and matches a portion of all 401(k) contributions each pay period. The employee terminates employment on June 30, 2008, but receives his final paycheck for accrued unused vacation time in July 2008. Because this payment took place within the plan year containing the date of termination, this compensation must be counted for plan purposes. Therefore, 401(k) deferrals must be withheld and transmitted to the 401(k) plan and a matching contribution must be made to the plan for the employee.
- *Example 2:* The same employee terminates employment on December 31, 2008, and receives his final paycheck for accrued unused vacation time after the plan year end in January 2009. Because this payment took place within 2-1/2 months after the employee's termination, this compensation must be counted for plan purposes. Therefore, 401(k) deferrals must be withheld and transmitted to the 401(k) plan and a matching contribution must be made to the plan for the employee.

Please note that in Example 2 the final paycheck was received in 2009 and the 401(k) deferrals were withheld in 2009, and the matching contribution was allocated in 2009, but for purposes of the plan they are considered compensation and contributions for the 2008 plan year.

Important issues to consider

When compensation and contributions are paid in the following year but counted in the prior year as in Example 2 above, there are important issues to consider:

- Many plan sponsors wish to complete their 401(k) testing as soon as possible in order to process any 401(k) refunds within 2-1/2 months after the close of the plan year (March 15 for calendar year plans) to avoid paying an excise tax. If compensation for a terminated employee is paid in the year following the date of termination, an accurate 401(k) test may not be possible before this deadline.
- Tracking the compensation and contributions for re-hired employees will become even more important. If an employee has post-severance compensation paid in the following year and is later re-hired in the same year, it will be important to sort out which compensation and contributions apply to each year.
- It may be possible for an employee to exceed the maximum 401(k) limit (e.g., \$15,500 for 2008) since payroll services track this on a calendar year basis. If a terminated employee has an additional 401(k) deferral in a year following the year of their date of termination after having reached the maximum 401(k) limit in that year, they would be in violation of the 401(k) limit.

What Do You Need to Do?

You should check with your payroll provider to make sure that compensation paid after termination of employment is treated properly under the new regulations. If you sponsor a 401(k) plan, tell your payroll department and payroll provider to withhold 401(k) contributions from final paychecks and post-severance compensation (but not true severance pay).

An alternative approach is to obtain new 401(k) deferral election forms from terminating employees electing zero (\$0) deferrals upon their date of termination. Please note that you cannot require this change, but terminating employees may be receptive to making this change.

When you provide your company's census data to us at the end of each plan year, you will need to be able report the amounts of any true severance pay, and the amounts of any compensation paid in the following year, but within 2-1/2 months of the employee's date of termination. This is required for plan years beginning after June 30, 2007. For calendar year plans, this is the 2008 plan year.

What Is Kravitz Doing?

We have updated our data collection procedure to request the additional compensation and contribution information necessary to comply with the new rules. In addition, we are preparing the plan amendments that the IRS requires to comply with the new regulations.

Please call your Kravitz consultant with any questions.

Kravitz is the largest firm of retirement consultants headquartered in California. We specialize in the design, administration, and management of virtually every type of retirement plan.