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THE SECTION 415 REGULATIONS ON POST-SEVERANCE COMPENSATION

In this Benefits Brief, we will provide a general overview of the IRS final regulations under Section 415 of the Internal Revenue Code governing the treatment of post-severance compensation under qualified retirement plans, which were issued in April 2007. In defined contribution plans, such as profit sharing and 401(k) plans, and employee stock ownership plans, Section 415 prescribes the maximum amount of employer and employee contributions and forfeitures that can be allocated to a participant in a given year. Section 415 also prescribes the compensation that must be used for this purpose, and that definition has been incorporated into a number of other statutory provisions relating to qualified plans. Although the regulations are a comprehensive amendment and restatement of the existing regulations and authoritative guidance governing Section 415 and contain many substantive changes, in this Benefits Brief we will only discuss the changes involving the treatment of post-severance compensation. As a result of a related change in the regulations under Section 401(k), these changes will be of particular importance in plans with a 401(k) or cash or deferred arrangement.

Uncertainty Under Current Law

Before the final regulations, the IRS had not issued any definitive guidance on the treatment of post-severance compensation. Given that, the question of whether compensation paid after someone ceased to be an employee of the plan sponsor should or had to be taken into account under a qualified retirement plan under pre-final regs law depended upon who you asked. Some employers and practitioners were of the view that compensation paid after the person was no longer an employee should be ignored, even if the amount was paid after cessation of the employer-employee relationship simply because payroll was paid in arrears. Thus, they would tell you that 401(k) deferrals should not be withheld from such compensation and that compensation should be disregarded in calculating the amount of the employer contribution to be allocated on behalf of the participant. But that view was not universally held nor followed. Similar disagreements have attended how the payment for unused vacation and personal leave time and severance pay should or must be treated for plan purposes. Fortunately, as explained below, compliance will be easier in the future with the issuance of this fairly straightforward guidance.

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FREE BACKGROUND INFORMATION IS AVAILABLE UPON REQUEST.

New Rules for Post-Severance Compensation

In 2007, the IRS issued final comprehensive regulations under Section 415 of the Internal Revenue Code and an amendment to the regulations under Section 401(k) that provide clear rules on the treatment of post-severance compensation under qualified retirement plans. For purposes of Section 415, compensation does not include payments made after the termination of employment unless the amounts are paid by the later of two and one-half months from severance from employment or the end of the limitation year in which the participant severs from employment and the payments are for:

- Regular pay for services rendered before termination, including overtime, shift differential, commissions, bonuses, or similar payments;
- The cashout of accrued sick, vacation or other leave provided the participant would have been able to use that leave if the employment had continued and the plan specifically provides for its inclusion; or
- Nonqualified deferred compensation that would have been paid at the same time had the employment continued.

For this purpose, the rules under Section 401(k) apply to determine whether a severance from employment has occurred, subject to some special aggregation rules to determine whether employers are related (and therefore whether there has been a "true" severance from the plan sponsor).

Notwithstanding the above, for Section 415 purposes, compensation also includes salary continuation payments for qualified military service or permanent and total disability if the plan so provides but these amounts are not subject to the time limits described above. However, any other payments after severance from employment, including severance pay, parachute payments, and nonqualified deferred compensation triggered by the severance from employment, are not considered compensation regardless of when paid.

For purposes of Section 401(k), post-severance compensation is subject to a participant's deferral election only if the amount is considered Section 415 compensation (as described above).

Effective Date

The final regulations are effective in the first limitation year beginning on or after July 1, 2007. In the case of a plan with a calendar year (January 1 through December 31) as its limitation year, these provisions are effective January 1, 2008. (In most cases, the plan year is the same as the limitation year but that is not always the case.)

Using a Different Definition for Allocation Purposes

A plan may utilize different definitions of compensation for different provisions under the plan. Despite this flexibility, most sponsors would be well advised to design their plans so that the same definition of compensation applies for all purposes under the plan.

Doing so minimizes the risk of error and avoids the annual testing that in most cases would otherwise be required to establish that the definition utilized is nondiscriminatory (i.e., it does not discriminate in favor of highly compensated employees). A definition of compensation that satisfies the Section 415 definition of compensation is a "safe harbor" definition that automatically satisfies the nondiscrimination rules and thereby obviates the need for annual plan testing of the compensation definition. Thus, an employer who wishes to utilize a definition of compensation for allocating particular contributions that does not include/exclude post-severance compensation as mandated under the Section 415 regulations will have to test its plan annually to assure that the definition is nondiscriminatory. For example, an employer who wishes to allocate the employer profit sharing contribution based on compensation that excludes post-severance compensation will have to be tested annually for nondiscrimination. Any such amendment to the compensation definition would also have to be executed before a participant has accrued a benefit under the prior formula.

Practical Effects on Plan Testing and Contributions

One byproduct of these new rules that needs to be considered in administration is that post-severance compensation may span two plan years. This will be more of a concern to plan administrators of plans with a 401(k) or cash or deferred provision or which have no conditions or limited conditions to share in the allocation of employer contributions. In 401(k) plans that are still subject to annual testing (i.e., non-safe harbor plans), this will mean that former employees will enter into the ADP test, and, if the plan permits matching or employee after-tax contributions, the ACP test, in the year following the year in which the employee terminates. In plans in which there are no allocation conditions or limited allocation conditions to share in the employer contribution, this will mean that employees may receive a contribution in the year following termination which previously they would not have been entitled to receive.

Plan Sponsor Action Items

In the past several years, there have been revolutionary changes in the IRS rules governing the timing of required plan amendments. While there is some disagreement among experts in the field as to when amendments to reflect the Section 415 regulations must be made to plan documents to keep them in compliance, the more conservative approach is to amend plans at this time to reflect these provisions. Depending upon the existing plan terms, a failure to timely amend the plan to reflect these provisions creates the potential for the plan to run afoul of the so-called "anti-cutback rules" or necessitate a greater employer contribution than would otherwise be required to assure no violation of those rules.

In addition to amending plan documents, plan sponsors will also need to review their payroll systems to assure that they are modified as necessary to reflect these provisions. Thus, plan sponsors need to assure that their payroll systems can accumulate the necessary data for benefit calculation and testing purposes and, in the case of plans with a 401(k) or cash or deferred arrangement, that employee elective deferrals are properly withheld only from eligible compensation.

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