retirement
plan news

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Post-severance Compensation Revisited

For years, there was no guidance on whether post-severance payments made to employees could be used for qualified plan purposes, e.g., for elective deferrals and matching and nonelective employer contributions. As a result, various interpretations existed.

The final Section 415 regulations help end the confusion. The regulations clearly state that certain amounts earned during the participant's employment but paid afterward are now included in Section 415 compensation. The 401(k) regulations were simultaneously modified to reflect that deferrals can be made only on payments that fall within the Section 415 definition.

Section 415 Compensation Amounts. According to the regulations, post-severance payments are to be included in compensation for qualified plan purposes if they meet all of the following criteria:

- The payment is regular compensation for services performed during an employee's regular working hours or compensation for services performed outside the employee's regular working hours (such as overtime or shift differential pay), commissions, bonuses, or other similar payments; *and*
- The payment would have been paid to the employee prior to a severance from employment if the employee had continued working for the employer; *and*
- The payment is made by the *later of* 2½ months after severance from employment or the end of the limitation year that includes the date of severance from employment with the employer maintaining the plan.

Example: An employee who is paid by the hour terminates employment on November 30. Her paycheck at that time reflects payments for services through November 15 only. On December 15, the now ex-employee receives a final paycheck for the amount she earned through November 30. This amount must be considered for Section 415 compensation purposes.

Commissions or bonuses earned while working and paid within the specified time period (the later of 2½ months or the end of the limitation year after severance) also must be considered for Section 415 compensation purposes.

Optional Compensation Amounts. The regulations address additional types of post-severance payments that an employer may choose to include as Section 415 compensation. Keep in mind that in order for the compensation to be eligible for qualified plan purposes, it must be for services rendered *before* the employee ceased working. Examples include:

- Pay for accrued vacation, sick, and other leave that could have been taken had the employee continued in employment;
- Pay differentials for employees who enter qualified military service; and
- Distributions from unfunded, nonqualified deferred compensation plans actually paid by the later of 2½ months or the end of the limitation year after severance.

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Post-severance Compensation Revisited *(Continued from page 1)*

Severance Pay Excluded from Definition of Compensation. Post-severance payments other than those just described — including *severance pay* — are not includible as compensation for qualified plan purposes, even if they are paid within the specified time frame. Theoretically, pure severance pay is not payment for services rendered and should not be considered plan compensation. Frequently, severance pay is a payment for the release of legal liability for terminating an employee's services. Other times, severance pay is a stated amount, such as $1,000, and is unrelated to any actual service.

Section 415 Limit and the Compensation Cap. The regulations coordinate the Section 415 limit with the compensation limit defined under Section 401(a)(17), which is $230,000 for 2008. Here's an example: An employee defers 5% of his salary per payroll on a salary of $310,000. His total deferrals for the year are $15,500 (the maximum allowed in 2008). But, when the annual compensation cap under Section 401(a)(17) is applied after year-end, the employee's deferral limit is measured against $230,000, not $310,000. Since he did not defer more than the Section 402(g) limit of $15,500, no amount is "excess deferral" that must be returned. However, for testing purposes, the imposition of the Section 401(a)(17) limit will cause the deferral rate to be 6.74%, not 5%.

Does an employee have to stop deferring as soon as the compensation cap of $230,000 is reached? No. The regulations clarified this. The 401(a)(17) compensation cap is an annual limit to be tested after year-end. Thus, if the employee deferred $11,500 on earnings of $230,000 by October and received a bonus in December, the employee could defer on the bonus with a separate deferral election at a higher percentage, even though the $230,000 limit was reached in October.

A simple way to avoid this issue is to defer a fixed-dollar amount per paycheck rather than a percentage of compensation. Simply take the deferral limit for the year and divide it by the number of payroll periods for the year. ❖

Partial Rollover Rules

Partial or installment distributions from a qualified plan account that contains after-tax amounts must consist of pro rata portions of after-tax and pretax amounts with two exceptions: after-tax contributions made prior to 1987 and partial direct rollovers.

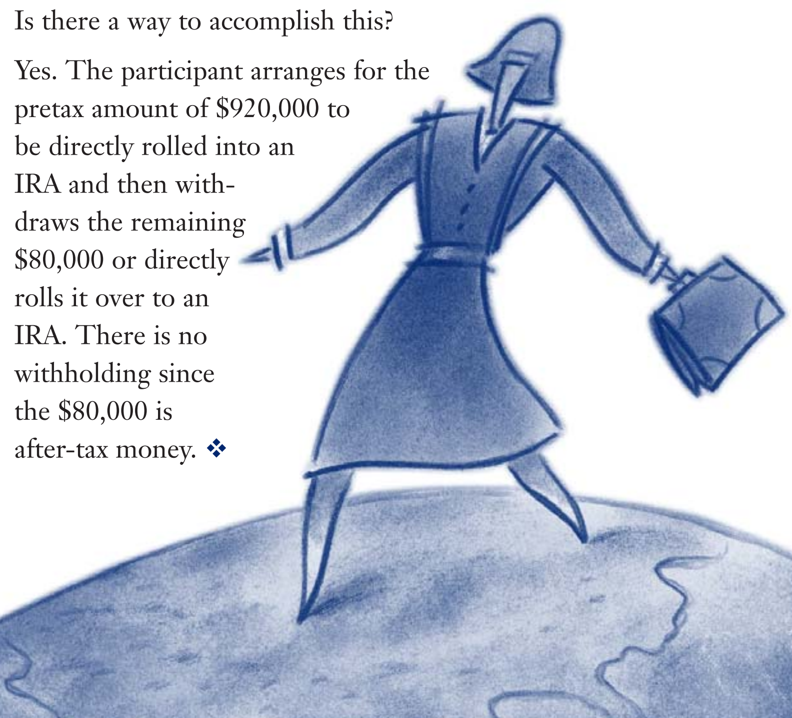
The Job Creation and Worker Assistance Act of 2002 (JCWAA) established an order for rollover amounts to eliminate the complexities of pro rata calculations. Specifically, when making a rollover, pretax dollars must be rolled over first.

A participant may directly roll over a portion of his or her qualified plan assets and take a distribution of another portion. If a partial distribution is made to a participant and it is eligible for rollover (i.e., contains pretax amounts), there is a mandatory 20% income-tax withholding.

Example 1: A participant leaves a job with a balance of $70,000. The pretax portion is $62,000 and the after-tax portion (contributed after 1986) is $8,000. The participant requests that $50,000 be directly rolled over to an IRA. The entire $50,000 would be pretax. The participant then requests that the balance of $20,000 be paid to him. Of the $20,000, $12,000 is pretax and eligible for rollover. Thus, a mandatory 20% federal income-tax withholding of $2,400 applies. The participant receives $17,600, which includes the $8,000 after-tax amount.

Example 2: A retiring plan participant has a $1,000,000 balance, including $80,000 in post-1986 after-tax dollars. The participant would like to withdraw the after-tax amount only and keep the pretax amount tax sheltered. Is there a way to accomplish this?

Yes. The participant arranges for the pretax amount of $920,000 to be directly rolled into an IRA and then withdraws the remaining $80,000 or directly rolls it over to an IRA. There is no withholding since the $80,000 is after-tax money. ❖



A retirement plan blackout period is defined as a period of more than three business days during which participants are "temporarily suspended, limited, or restricted" from directing or diversifying the assets in their accounts and from obtaining distributions or loans. Participants must be notified in advance of a blackout period.

Timing Rules. Participants and beneficiaries must be provided with a blackout notice between 30 and 60 calendar days (not business days) before the last date on which the about-to-be-restricted transactions may be exercised. For example, if the last day participants can make a change to their investments is June 20, the notice must be sent between April 21 and May 21. If the dates change after the notice is given, then a second notice must be provided.

Instead of providing exact dates, a sponsor may indicate the weeks that the blackout period will begin and end. With this option, the sponsor must provide a toll-free number and/or a website that will provide the exact beginning and ending dates.

Specifying Transactions. The blackout notice language should address only the specific rights that are being suspended. For example, if a plan does not permit participants to direct their investments, the notice need not include language about changing investments. It should include language about suspended rights, such as receiving plan loans or withdrawals.

The same notice may address different restrictions. For example, information about a 25-day blackout for withdrawals and a 20-day blackout for investment changes may be combined in the same notice. Blackout notices are only required when rights are suspended for the entire plan; single participant plans are exempt.

Events That Are Not Blackouts. Not every instance of suspended or restricted access is considered a blackout. Here are a few events that are not:

- QDRO restrictions on an individual's account
- Restrictions on an individual account or third-party actions (e.g., a tax levy or beneficiary dispute)
- "Regularly scheduled" restrictions, if disclosed beforehand in an SPD, SMM, enrollment form, or investment material (e.g., a regularly scheduled freeze on investment changes)
- Permanent restrictions are not blackouts (e.g., eliminating loan provisions or participant investment direction from a plan. Other notices will be required in these cases.)
- Restrictions on investment education services

Delivery Methods. A blackout notice may be provided by electronic means; first-class, certified, or express mail; designated private delivery service; hand delivery; or interoffice mail. If the notice is sent by mail, the 30-day period starts on the date it is mailed. (A notice sent to a participant's or beneficiary's last known address fulfills the requirements.) If the notice is sent electronically, the 30-day period starts on the date it is sent. The blackout notice may be mailed with other materials, provided it is prominently identified.

Exceptions to the 30-day Requirement. In the following cases, notices must be given "as soon as reasonably possible." The 30-day time period may be shortened if:

- Postponing the blackout period would violate ERISA's exclusive purpose rule or prudence rule,
- The blackout period begins due to events that were unforeseeable or circumstances that were beyond the control of the plan administrator, or
- The blackout period occurs solely in connection with a merger, acquisition, divestiture, or similar transaction involving the plan sponsor.

If providing a notice is impossible, then none is required.

Penalty for Noncompliance. If the blackout notice is late, a $100-per-day late penalty will be imposed for each participant and beneficiary who does not receive the notice. The plan administrator — not the plan — is liable for the penalty.

Note: Directors and executive officers are prohibited from trading in employer stock during a blackout period. ❖

recent developments

■ **QDIA Technical Corrections.** In October 2007, the Department of Labor issued final regulations implementing the “qualified default investment alternative” (QDIA) provisions of the Pension Protection Act of 2006. The QDIA rules offer plan fiduciaries a safe harbor from liability when providing default investments for workers who fail to give instructions about how their plan contributions should be invested. QDIAs are designed to encourage the investment of employee assets in investment vehicles that are appropriate for long-term retirement savings.

The DOL has since issued technical corrections that affect three areas of the final regulations. The corrections 1) clarify the preamble example on “round-trip restrictions,” 2) add “a named plan fiduciary” to the list of who can manage a QDIA, and 3) correct the “grandfather” relief for stable value funds. Field Assistance Bulletin 2008-03 provides guidance in an FAQ format on issues that were raised after the final regulations were published.

■ **PPA Testing Changes for Plan Year 2008.** Although the PPA was passed in 2006, some changes are effective beginning with the 2008 plan year.

Gap period income eliminated. Starting with testing performed in 2009 for the 2008 plan year, income on refunds made due to failed ADP/ACP tests will not have to be calculated for the GAP period (January 1 following the test year to the distribution date). However, GAP period income must still be calculated on excess deferrals.

Eligible automatic contribution arrangements. EACA plans will have six months after the plan’s year-end (versus 2½ months for other 401(k) plans) to make a refund for a failed ADP/ACP test. Thus, the 10% penalty to be paid by the employer on late corrective distributions will apply after six months rather than 2½ months.

Corrective distributions. Distributions to correct failed ADP/ACP tests during the first 2½ months (or six months, as applicable) are now taxable in the year distributed. Prior to plan year 2008, only de minimis amounts of less than $100 (excluding earnings) were taxed in the year distributed. Starting with testing for plan year 2008, all refunds of failed ADP/ACP tests will be taxed in the year distributed. Thus, the de minimis rule will no longer be a concern. In addition, off-calendar-year plans will no longer have to refund deferrals based on the FIFO method, which was always problematic. ❖

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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