

# ASPPA *asap*

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## Code Section 415 Amendments

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### ▲ Background

Revenue Procedure 2007-44 establishes different deadlines for adopting interim and discretionary amendments. Discretionary amendments must be executed by the end of the plan year during which the provisions are implemented; interim amendments need not be executed until the due date for filing tax returns, including extensions, for the tax year during which the change was implemented, if that date is later than the end of the plan year. Of course, special rules might apply for some amendment deadlines, as they do for the amendments under the Pension Protection Act of 2006.

ASPPA *asap* 07-23, issued in October 2007, informed members about the IRS release of its “*List of Required Amendments for 2007.*” There continues to be a lot of confusion, however, as to when Section 415 amendments must be adopted.

### ▲ §415 Amendment

The IRS issued proposed Section 415 regulations in May 2005. One of the key changes related to the issue of post-severance compensation and its inclusion in the §415(c) definition of Compensation. The final regulations, issued in April 2007, are effective for limitation years beginning July 1, 2007, and later. (See ASPPA *asap* 07-10 for a more in-depth discussion of these regulations.) Because of the timing of the release of the final regulations, providers of pre-approved prototype and volume submitter defined contribution plans were unable to include the code §415 changes in the EGTRRA documents that are currently in the approval process; therefore, Section 415 changes will have to be incorporated by separate amendment. In fact, depending on timing, the Section 415 amendment may need to be attached to both the employer’s GUST and EGTRRA documents.

The language will be included in the EGTRRA pre-approved defined benefit plans that are currently being drafted and which will be submitted before the end of January 2008. Since those

plans will likely not be utilized until at least 2010, however, Section 415 amendments will be required for the GUST defined benefit documents.

For sponsors with calendar limitation and tax years, an amendment to comply with the final regulations theoretically does not have to be executed until sometime in 2009. This amendment may need to be executed earlier, however, if there is a possibility of a code §411(d)(6) cutback (see below).

### ▲ Definition of Compensation

In order to address the Section 415 amendment deadline, employers need to consider the effect of the various definitions of **compensation** used for allocation purposes; nondiscrimination testing under code §§401(k) and (m) and §401(a)(4); determining who is a key or highly compensated employee; whether someone has exceeded the annual additions limit; and how much must be allocated as a top-heavy minimum. If this is not confusing enough, the regulations under Section 415 allow the use of alternative definitions of compensation such as code §3401(a) and §§6041/6051 for certain purposes.

### ▲ Post Severance Compensation

The IRS has always held—and still holds—that severance pay does not qualify as compensation for qualified plan purposes. Accordingly, such amounts are not included for Section 415 calculation purposes and, thus, may not be the basis for withholding elective deferrals. What has confused matters, however, is that some plans excluded all amounts received by the participant after separation of employment, and those amounts may not have been entirely “severance” pay.

The final regulations specifically make clear that some amounts that accrued before separation, but which are not paid until after the employee’s termination date, must be included in a plan’s definition of compensation for Section 415 purposes.

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For example, an hourly paid employee terminates employment on Friday November 30, 2008. He receives a paycheck that day, but it only reflects earnings through November 17, 2008. On December 14, 2008, a final paycheck is issued for the period November 18–November 30. Previously, the plan could exclude these amounts. Now the plan *must* consider these amounts for Section 415 purposes and likely allow deferrals against them. Among the other implications is that a non-key employee would need to receive a top-heavy minimum allocation on the total amount paid, if the plan were top-heavy.

A couple of clarifying points:

- Only amounts that would be received by the employee if he had not terminated employment may be counted.
- Only amounts received by the later of 2½ months after termination of employment or the end of the limitation year during which termination occurred may be counted. Thus, in the example above (assuming a calendar year limitation year) with the termination on November 30, 2008, only amounts received by February 15, 2009, would be included.
- The employer may, but need not, choose to include accrued vacation and sick pay at the time of termination, if it is paid to the participant within 2½ months or, if later, the end of the limitation year period.
- For the first time ever, the employer may elect to include amounts received from a non-qualified deferred compensation plan, if the amounts are paid within the above referenced time frame, based on the settlement option chosen by the participant before the amounts were deferred. This has the potential to impact key and highly compensated employee status.

### ▲ Cutbacks Under Code §411(d)(6) May Drive Amendment Timing

The potential for cutbacks under code §411(d)(6) can impact the timing of the Section 415 amendment. Unfortunately, there is nothing in the IRS guidance discussing the interplay of the final Section 415 regulations and the anti-cutback rules. Regardless of the general rules provided in Rev. Proc. 2007-44 regarding the timing of amendments, an amendment cannot result in a violation of the anti-cutback rules of code §411(d)(6).

Whether an amendment raises cutback issues depends on whether there was a change in the plan's allocation formula that causes a reduction after a participant has earned the right to share in the allocation. A change in the definition of compensation used for allocations is considered by the IRS to be a change to the allocation formula. (TAM 9735001) Thus, an

amendment may be required before any participant accrues a benefit.

Hypothetically, this could be in as little as three months into a plan year if a standardized prototype is being utilized, or earlier if no service requirements are imposed. For example, the definition of compensation is critical to the calculation of safe harbor matching or non-elective contributions; therefore, the §415 amendment may affect the basis for computing the safe harbor contribution.

When will there be code §411(d)(6) problems? If a plan allocates employer contributions using a flat percentage of participants' compensation, even multiple percentages in a cross-tested plan, there should be no cutback problem. Assuming every participant will receive an allocation of, for example, five or ten percent of their compensation and the definition of compensation is amended to add the post severance pay, then there is no cutback issue. Terminated employees will receive an increased amount (based on the amended definition) and continuing workers will not see any change in their allocation amounts.

There is, however, a potential for a cutback where the employer contributes a discretionary amount, say \$10,000, that will be allocated among all of the participants. If the amendment is made after participants have accrued benefits and now terminated participants have a higher amount of compensation used in the allocation, then continuing employees theoretically face a cutback in benefits. Of course, this can be remedied by the employer not making the discretionary contribution that year. While this is drastic, it is a possible short-term fix to the cutback problem. Plans using the excess integration method will likely have similar issues since an increase in one participant's allocation will likely result in a reduction to one or more other participants. Again, this is only problematic if the amendment is made after participants have accrued a right to receive an allocation. Additionally, if the compensation definition is changed to now exclude accrued vacation or sick pay that was previously included, there would be a potential cutback issue.

### ▲ Timing of Benefit Accrual

When do participants accrue their benefits? If there are no accrual requirements, such as a minimum number of hours worked, then it is the first hour of service credited. In a standardized prototype with a 500-hour rule, the IRS has previously issued guidance indicating that accrual occurs after three months. Thus, to evaluate which plans may have a cutback problem, a short-cut would be to determine if more than three months of the plan year had expired. You could then look at

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those plans to see if any participant had more than 500 hours credited. In plans where three months have not expired, it is less likely that any participant has been credited with more than 500 hours.

When reviewing a plan with a 1,000-hour rule, apply a five-month rule to quickly determine which plans may be impacted. With a plan with a last-day rule, there is no accrual until the last day of the year and, therefore, the timing of the Section 415 amendment may be delayed until the end of plan year (assuming the plan does not have any safe harbor allocation).

#### ▲ Which Plans Need to be Amended

Be aware that there are different answers for individually designed plans and pre-approved plans. A complicating factor is that Section 415 is based on limitation years and the IRS guidance as published addressed amendments as first being required for plan years beginning July 1, 2007. Of course, while most plans have the same plan and limitation year that is not always the case.

##### **Pre-Approved Plans**

For pre-approved plans, the timing of the amendment varies. For standardized plans with calendar year tax and plan years, the employer probably wants to have the amendment done **before** March 31, 2008, if there is a potential for code §411(d)(6) problems. If there is no cutback issue, then the amendment can be done by the due date for filing the employer's 2008 federal income tax return. This might allow for simultaneous execution of the employer's EGTRRA restatement.

If the employer's plan year began on or after July 1, 2007, but before January 2008, the employer has until at least June 30, 2008, to amend, again, unless there are cutback issues. It is unlikely that they will be able to execute the amendment simultaneously with their EGTRRA restatement.

For non-standardized and volume submitter plans with plan years starting January 1, 2008, the analysis is very similar to that above. The May 31, 2008, date, however, should be substituted for March 31 date above, if there are cutback issues. If there are no cutback issues, attempts should be made to execute the Section 415 amendment simultaneously with the employer's EGTRRA restatement. Employers will likely have until sometime in 2009 to execute the amendment, depending on their tax filing deadlines.

##### **Individually Designed Plans**

For individually designed plans, documents under Cycles A and B of the IRS document restatement process clearly did

not contain language from these final regulations. Minimally, those plans must be amended to add appropriate compensation definition language for top-heavy and highly compensated employee purposes. To the extent the definition of compensation for allocation purposes did not include any reference to regular pay that is earned before, but paid after, termination, an amendment may be required. A discretionary amendment may also be made for accrued vacation and sick pay and nonqualified deferred compensation amounts as addressed above. The same would apply to most Cycle D plans and all Cycle E plans.

If we assume that most individually designed plans contain a last day rule, the earliest those plans would need to be amended is June 30, 2008, so long as there are no potential cutback problems requiring an earlier amendment (such as safe harbor allocations). Some employers will be able to amend as late as September 15, 2009, the due date, with extensions, for filing the corporate tax return.

For Cycle C plans, with submissions starting February 1, 2008, and ending January 31, 2009, it is likely that the amendment for Section 415 will be part of their overall submission.

#### ▲ What About Testing?

While not directly related to the issue of the timing of Section 415 amendments, a secondary concern is how the change in the definition of compensation might impact §§401(k) and 401(m) testing. For example, a participant terminates in December of 2008, but some amounts that are now required to be counted under the Section 415 definition of compensation are not paid until January, February or possibly even early March of 2009. Is this amount included in 2008 compensation for testing purposes or does it count only in 2009? Could this amount be included in 2008 compensation for testing purposes, but in 2009 for allocation purposes?

Unfortunately, the final regulations do not address this issue, even though ASPPA GAC, through its comment letters, previously requested (and will likely again request) the issuance of guidance on this point. Thus, we have no definitive answer from the IRS/Treasury. The practitioner community seems to be split on the answer to this question. The more conservative approach is to accept that most pre-approved plans are written to be operated utilizing a compensation definition that is on a cash basis and does not recognize any accrual amounts. Thus, any compensation actually paid in 2009 would be treated as part of 2009 and used in 2009 testing, even though no services were rendered during that year. If it were required to be treated as a 2008 amount, an obvious problem is that you may not have all

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the data until March of 2009, which would hamper the ability to do timely testing. An overriding question is whether this alternative definition of compensation under §414(s), will always meet the nondiscrimination requirement under Reg. §1.414(s)-1(d)(3) where these delayed amounts vary significantly from year to year.

However, the conservative approach is not without its own problems: if the deferral percentage for the carryover to the following year is modified by the participant from the prior year percentage, then the amounts carried over to 2009 could significantly skew the testing result. For example, consider an NHCE who decides to make a zero deferral or, possibly more damaging, an HCE who elects to defer 100% of that small compensation amount resulting from the carryover. In the latter case, that small dollar amount (but high percentage) deferral could cause a failure in the ADP test that significantly reduces the ability of other HCEs to defer in that year.

We expect that ASPPA will continue to push for more guidance on this issue; meanwhile, all we can suggest is that you stay tuned.