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§415 Reg Problem: Trailing Income Issues

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The final §415 regulations provided some new wrinkles to the issue of compensation following termination of employment. (see ASPPA *asap* 08-01). Specifically, let's discuss the issue of trailing compensation (the income that comes in with the paycheck or two *following* termination of employment). It appears that many (if not most) plans are electing to count this trailing compensation for plan purposes (to do otherwise, the employer would have to report income *only* until the date of termination, as well as prohibit deferrals out of those subsequent checks in §401(k) plans, a task that might be quite difficult to monitor). We will assume these checks arrive within the 2½ months provided for in the final §415 regs, but let's look at the specific instance where they cross over a calendar year plan; for ease of discussion, let's assume a calendar year plan year.

Let's use as an example a participant who terminates December 28, 2008, but receives final paychecks in January, 2009 (a few days of pay plus accumulated sick time and vacation). The final §415 amendment to the plan was adopted and it does not cut off compensation at termination, so the compensation paid in calendar year 2009 will count for §415 purposes. Let's also assume that the plan uses that same definition of compensation for allocation purposes. Although the participant has no hours of service in 2009, we must still count his or her compensation in 2009. What effect might that have?

The following is our best guess on what the rules require; ASPPA GAC has asked the IRS for clarification but we have yet to receive such clarification. (GAC will continue asking.) Let's assume we have a §401(k) plan that utilizes the non-elective 3% safe harbor. That small amount of compensation in 2009 will generate a 3% of pay allocation for 2009, even though the participant has no hours of service in that year. In addition, if the plan is utilizing the gateway test for non-discrimination testing purposes, an additional 2% of pay will need to be provided (or the 1/3 test met, if less). In this type of plan, the small allocation (say, 5% of a very small dollar amount) should not cause great

concern to the plan sponsor, and the §401(k) testing is not affected (but see below for other issues). In a non-safe harbor plan, the deferral that is made out of that small amount of compensation, however, could have significant effects, either good or bad.

If the employee is an NHCE who is paid \$100 of accumulated sick pay, he might decide to defer all of it as a §401(k) deferral. That would give us a 100% deferral rate for that participant in 2009 for purposes of the ADP test. Likewise, if the participant is an HCE and makes a similar decision, we would have to include his 100% deferral rate in the ADP test for the HCEs for 2009. The results of those two possibilities could produce significantly different results in our plan testing. In the first instance (the NHCE), we would have a very favorable deferral rate to add to our testing, making passing the ADP test much more likely. Conversely, in the second instance (the HCE), we might end up with a disastrous result in our ADP calculation.

Similarly, in a plan that was utilizing general testing for non-discrimination, the very high EBARs that result from a 100% deferral rate would need to be counted in the average benefit test and could have similar results with regard to passing those tests.

Lastly, let's assume a balance forward plan that distributes the benefits in the year following the year of participant termination. Our participant terminated in late 2008 and received his December 31, 2008 account value distribution sometime in 2009. The participant would then also have a small amount of carryover compensation that produces an additional account balance at the end of 2009, which would require another distribution (in 2010) with the appropriate election forms (possibly including spousal waivers) and 1099-Rs.

We point this out just so that you are aware of this situation which can occur in the right (or wrong) circumstances and might produce results that are very much unanticipated.