

All 401(k) and other defined contribution plans (DC) need to be amended to comply with the final Internal Revenue Service Code §415 regulations. This **Compliance Alert** explains the changes made under the final regulations and the issues plan sponsors need to consider.

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Final §415 Regulations Plan Amendment for 401(k) and Other Defined Contribution Plans

Earlier this year, the Internal Revenue Service (IRS) issued final regulations regarding the contribution limitations imposed under §415 of the Internal Revenue Code (Code). The final §415 regulations, effective January 1, 2008 for calendar year plans, affect every qualified plan, and in accordance with IRS procedures, all plans must be amended to comply.

Background

Code §415 limits the amount of contributions (i.e., "annual additions") that can be provided under a Defined Contribution plan: Annual additions made to a participant's account in a Defined Contribution plan during a limitation year cannot exceed the lesser of 100% of the participant's compensation or \$40,000, adjusted annually for cost of living increases. The 2008 adjusted dollar limit is \$46,000, plus an allowable \$5,000 catch-up for 401(k) participants who are at least age 50.

The final §415 regulations modify the allowable definition of compensation by providing specific rules regarding when amounts received following severance from employment are considered compensation and when such amounts are permitted to be deferred to a 401(k) plan.

Final §415 Rules

Following are the key changes affecting 401(k) plans under the final §415 regulations.

Definition of Post-Severance Compensation

As under prior rules, the final §415 regulations provide for safe harbor alternative definitions of compensation when determining a participant's §415 compensation limit, such as wages included within the meaning of Code §3401(a) (for purposes of income tax withholding at the source) and W-2 pay. The safe harbors are adjusted for any pre-tax deferrals such as to a 401(k) plan or a Code §125 (cafeteria) plan.

The final regulations provide that certain pay received after severance from employment must be included for §415 purposes and certain categories may be included on an

optional basis. In both cases, however, compensation is only included if paid by the later of (i) 2-1/2 months after the participant's severance of employment, or (ii) the end of the limitation year (calendar year if a calendar year plan) that includes the severance date (post-severance payment period).

- Regular pay (mandatory). Code §415 compensation *must* include the participant's regular compensation for services rendered during the participant's regular working hours that is paid during the post-severance payment period. In addition, §415 compensation must include the participant's compensation for services rendered outside the participant's regular working hours (such as overtime or shift differential), commissions, bonuses and other similar compensation that would have been paid to the employee and normally included as compensation before a severance from employment had the employee continued in employment (provided the amounts are paid during the post-severance payment period).

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. The plan must consider this pay for §415 purposes and likely allow 401(k) deferrals against it.

- Leave cashouts (optional). Payments for unused accrued bona fide sick, vacation, or other leave may be included in §415 compensation but only if (i) the employee would have been able to use the leave if employment continued, (ii) the amounts would have been included in the definition of compensation if they were paid prior to the participant's severance from employment, (iii) they are paid during the post-severance payment period, and (iv) the plan so provides.
- Deferred compensation (optional). Amounts received by an employee under a nonqualified unfunded deferred compensation plan *may* be included in §415 compensation if the payment is made within the post-severance payment period but only if the payment would have been made at the same time if employment had continued.
- Other types of compensation (optional). There are other types of optional compensation such as payments while on military duty and payments to an individual who is permanently and totally disabled.

Compensation Limit

In a major change from prior rules, the final §415 regulations apply the Code §401(a)(17) compensation limit (\$230,000 for 2008) to §415 compensation when used to determine the §415 compensation limit.

Salary Deferrals

An accompanying change to the Code §401(k) regulations makes clear that salary deferral elections may only be made with respect to amounts that are included in §415

compensation. This means that deferrals may not be made from amounts paid after severance unless the amounts meet the 2-1/2 month timing and other requirements defined above.

Important Note Regarding Plan (Allocation) Compensation

The final regulations only modify compensation that is used for Code §415 (which is used for purposes of determining highly compensated employees and applying the top-heavy provisions) and deferral compensation (so that a participant cannot defer out of post-severance compensation that is not §415 compensation). Code §415 compensation, however, is the basis for determining whether compensation is nondiscriminatory under Code §414(s). Thus, if "plan compensation" - compensation used for allocating employer contributions - is modified to equal the §415 definition of compensation, then the compensation automatically satisfies Code §414(s) and is deemed to be nondiscriminatory.

The IRS has not issued updated guidance regarding the impact of modifying a plan's definition of compensation to something other than the Code §415 definition.

Next Steps

Plan sponsors should confer with their document providers if they have not yet been advised of the final §415 regulations. In determining how to amend the plan definition of Code §415 compensation, plan sponsors should consider those changes that may be needed in payroll so that the appropriate items of compensation are properly included or excluded for purposes of computing §415 compensation.

Contact ERISA Compliance Associates, LLC, at 619-233-3054 if you have any questions regarding the Code §415 regulatory changes or would like to discuss how the changes affect your specific plan provisions and administration.