

January 2006

Post-Termination Pay - Proposed 415 Regs Suggest Changes To Come

Earlier in 2005, the IRS issued proposed regulations (the "Regs") under Section 415 of the Internal Revenue Code, which governs the limitations on benefits and contributions under tax-qualified retirement plans. The proposed regulations are comprehensive and incorporate the many changes reflected in Internal Revenue Service notices, revenue rulings, and other guidance since the last time comprehensive regulations were published in 1981. This Management Alert discusses only post-termination compensation changes. In some cases, employers may rely on this new guidance immediately (as discussed in more detail below with respect to the effective date).

Background

Section 415 establishes limits on the benefits and contributions to tax-qualified plans. For a defined contribution plan, contributions and forfeitures (called "annual additions" under Section 415) may not exceed the lesser of \$44,000 (for 2006) or 100% of the participant's compensation. For defined benefit plans, the annual normal retirement benefit may not be more than the lesser of \$175,000 (for 2006) or 100% of the participant's compensation. Section 415 includes a definition of compensation used to determine these limits. Until now, express guidance regarding whether and to what extent post-termination pay could be included in Section 415 compensation has not been available.

The Regs provide important guidance regarding when post-termination payments may be considered compensation for purposes of Section 415 and when such amounts are permitted to be deferred pursuant to Code Sections 401(k) or 457(b), or treated as contributions excluded from gross income under Code Section 403(b). Specifically, the timing rules under the new regulations create two exceptions to the general requirement that in order to be considered compensation for 415 purposes, amounts must be paid (or treated as paid) prior to severance from employment with the employer maintaining the plan. Under corresponding amendments to the regulations under Sections 401(k), 403(b) and 457(d), post-termination payments may not be deferred by employee election unless the payments satisfy one of the two exceptions.

2½ Month Exception

Section 415 compensation may include compensation paid within 2½ months following the employee's severance from employment, *provided* (i) the payment would have been made if the employee had continued in the employ of the employer and the payment is regular compensation for services (including overtime, shift differentials, commissions, bonuses or other similar compensation), or (ii) the payment is for accrued bona fide sick, vacation, or other leave (but only where the employee would have been able to use the leave if employment had continued). When considering whether to include such compensation in 415 compensation, employers should examine how their systems currently identify 415 compensation and the extent programming changes would be needed.

Military Service Exception

Compensation paid by reason of qualified military service to an individual who is not currently performing services for the employer may be included in Section 415 compensation as long as it is not more than the person would have received if he had continued to perform services. If employers provide full or partial pay for any period of qualified military leave and would like to include this in 415 compensation under this rule, they should also review the definition of eligible compensation under the plan and determine if such definition needs to be amended in the same manner.

If neither of these exceptions are satisfied, post-termination pay may not be taken into account for purposes of Section 415.

For example, payments made under an employer's severance plan and paid solely on account of severance are post-termination payments but could not be included in Section 415 compensation under the employer's defined benefit pension plan and would not be eligible for elective deferral under the employer's 401(k) plan, because severance payments do not meet the exceptions. On the other hand, bonuses or commissions paid after termination may be included in Section 415 compensation and may be eligible for 401(k) deferral but only to the extent they are actually paid within the 2½ month period after termination.

End of year payments

The Regs also establish a *de minimus* rule for payments made after the 415 limitation year which is frequently the calendar year. In general, in order to be taken into account for a limitation year, 415 compensation must actually be paid (or made available) within the limitation year. However, a plan may provide that compensation earned during the limitation year but not paid during that year may be included within the meaning of Section 415 compensation if (i) the amounts are paid “during the first few weeks” of the following limitation year, (ii) they are included on a uniform and consistent basis with respect to all similarly situated employees, and (iii) no compensation is included in more than one limitation year. Here again, examining the current programming for the collection of 415 compensation data may affect an employer’s decision on compliance with this rule.

Effective Date

The Regs are proposed to apply to limitation years beginning on or after January 1, 2007 and cannot be relied on as guidance before final regulations are issued. However, the preamble to the Regs expressly provides that the modifications relating to the timing of compensation payments and the deferral of such payments under Code Sections 401(k) and 457(d) discussed in this Management Alert may be relied on pending the issuance of final regulations. The corresponding changes under Section 403(b) are not referenced in the preamble and it is unclear whether that portion of the proposed regulations may be relied on immediately.

Compliance Strategy

As a result of this new guidance, employers and plan administrators should review plan terms and plan administration to determine if any post-termination pay is impermissibly included in the definition of compensation for purposes of the 415 limitations, as well as with respect to pay eligible for deferral. Alternatively, if no compensation paid after termination has been taken into account for these purposes, employers and plan administrators may wish to recognize post-termination pay that qualifies under one of the exceptions and, if necessary, make corresponding changes to plan terms and administrative practices. Identifying post-termination pay that satisfies the 2½ month exception, for example, may require changes to a plan sponsor’s payroll system as well as changes in overall plan administration which should be considered before making plan amendments. Finally, plans should be reviewed to determine if the terms prohibit the application of the *de minimus* exception discussed above and amended, if necessary.

For further details and guidance regarding the requirements under Section 415 of the Code, please do not hesitate to contact your Seyfarth Shaw LLP attorney or any Employee Benefits attorney on the website at www.seyfarth.com.

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