

### Treasury Finalizes Section 415 Regulations, and Compensation Issues Emerge

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Earlier this year, the Internal Revenue Service (IRS) issued final regulations regarding the limitations imposed under section 415 of the Internal Revenue Code (Code). The final regulations provide plan sponsors and practitioners with one comprehensive set of rules under Code section 415. Such rules were previously described under regulations dating back to 1981 and a plethora of subsequent IRS notices and other guidance. Plan sponsors must make certain decisions and implement required changes and clarifications with regard to the compensation considered for purposes of Code section 415.

The regulations are generally applicable to limitation years beginning on or after July 1, 2007.

The following is a description of most of the clarifications and changes—required and optional—regarding Code section 415 compensation (415 compensation). Special rules under the regulations regarding the treatment of compensation earned by nonresident aliens are not addressed in this LawFlash.

- **Change to “currently includible” definition of compensation**

In applying the limits under Code section 415, many employers use the “currently includible” definition of compensation. This definition generally includes the participant’s wages, salaries, and other amounts received for his or her services rendered in the course of employment to the extent that the amounts are includible in the participant’s gross income (or to the extent amounts would have been received and includible in gross income but for an election under Code section 125(a), 132(f)(4), 402(e)(3), 402(h)(1)(B), 402(k), or 457(b)). This definition also excludes certain types of remuneration, including contributions to deferred compensation plans to the extent they are not includible in the employee’s income for the year in which they were contributed. The final regulations clarify that amounts includible in a participant’s gross income due to noncompliance with Code section 409A are included in this definition of 415 compensation. As under the prior rules, the new regulations provide for safe-harbor alternative definitions, such as wages included within the meaning of Code section 3401(a) (for purposes of income tax withholding at the source) and W-2 pay. The safe harbors are adjusted for amounts that would have been received and been includible in gross income but for an election under Code section 125(a), 132(f)(4), 402(e)(3), 402(h)(1)(B), 402(k) or 457(b). In addition, the safe harbors must reflect the mandatory adjustments described below and may utilize the optional ones as well.

- **Compensation paid after severance from employment**

The final regulations provide that certain remuneration paid after severance from employment is includable in 415 compensation (irrespective of which Code section 415 definition of compensation is used). However, these items are only included to the extent that they are paid by the later of (i) 2-1/2 months after the participant's severance from employment or (ii) the end of the limitation year that includes the participant's severance from employment date (post-severance payment period). Even if paid within the post-severance payment period, in no event may severance pay be included in 415 compensation.

Under the final regulations, certain categories of compensation paid during the post-severance payment period *must* be included for section 415 purposes, and certain categories *may* be included on an optional basis, as described below. However, in both instances, only compensation paid during the post-severance payment period may be included.

- Regular pay (mandatory). Section 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, or other similar payments that would have been paid to the employee before a severance from employment had the employee continued in employment with the employer (provided such amounts are paid during the post-severance payment period).
- 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 had 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 (i) the payment would have been paid to the employee at the same time if he or she had continued in employment, (ii) the payment is made during the post-severance payment period, (iii) the payment is includable in the employee's gross income, (iv) the amounts would have been included in the definition of compensation if they were paid prior to the participant's severance from employment, and (v) the plan so provides.

- **Salary continuation payments for military service and disabled participants**

The following types of remuneration *may* be included in a participant's 415 compensation, if the plan so provides:

- Qualified military service. Payments to a participant not currently performing services for the employer by reason of qualified military service (as defined under Code section 414(u)(1)), to the extent those payments do not exceed the amounts the individual would have received if he or she had continued performing services for the employer.

- Disabled participants. Payments to a participant who is permanently and totally disabled, provided he or she is not a highly compensated employee immediately before becoming disabled; or in the event the participant is a highly compensated employee, the plan provides for the continuation of compensation on behalf of all participants who are permanently and totally disabled for a fixed or determinable period.

- **Interaction of 415 compensation with compensation limits under Code section 401(a)(17)**

A plan's definition of compensation for purposes of Code section 415 for a given year may not exceed the maximum amount of compensation recognized for purposes of limiting contributions or benefits payable with respect to a plan under Code section 401(a)(17) for that same year.

### **Action Items to Consider**

- **Payroll.** Plan sponsors should analyze whether any changes will need to be made to their payroll systems so that the appropriate items of compensation are properly included or excluded for purposes of computing 415 compensation. It might be especially cumbersome to capture the appropriate remuneration paid during the post-severance payment period, especially for plans using the W-2 safe harbor.
- **Salary deferrals.** An accompanying change to the Code section 401(k) regulations makes clear that cash or deferral elections may only be made with respect to amounts that are included in 415 compensation. That is, deferrals may not be made from amounts that are received after a participant's severance from employment unless the amounts meet the timing and other requirements set forth above.
- **Plan allocations based on 415 compensation.** If allocations of contributions under the plan are based on 415 compensation, plan sponsors should consider how the changes in 415 compensation will impact the plan and consider whether to make any changes to the plan.
- **Limitation year.** If the limitation year does not coincide with the plan year, the effective date and amendment due date may be earlier or later than expected.
- **Section 409A plans.** Employers should consider the changes to 415 compensation as they evaluate and amend any deferred compensation plans providing benefits in excess of the limits under Code section 415.
- **Other areas of compliance.** Other areas of plan compliance utilize 415 compensation. For example, the determination of whether a participant is a highly compensated employee and the determination of a required minimum contribution under the top-heavy rules are both based on 415 compensation. The plan sponsor should consider how the changes in 415 compensation will affect these areas.

### **Plan Amendments**

Plan amendments must be adopted by the later of (i) the due date (including extensions) for the plan sponsor's corporate income tax return for the fiscal year that includes the date on which the regulations

are first effective, or (ii) the last day of the plan year that includes the date on which the regulations are first effective. If the limitation year, plan year, and fiscal year are coincide with the calendar year, then the due date for adopting the amendments is the due date for filing the corporate income tax return (plus extensions) for the 2008 limitation year. In addition, the IRS has indicated that plans filing for a determination letter under Cycle B must include amendments to comply with the 415 regulations even if this is earlier than the otherwise applicable due date (see Notice 2007-3).

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