

## Advance Planning

Due to recent regulatory developments, employers that sponsor 401(k) plans or offer 403(b) programs may need to plan ahead for potential changes to plan operations or plan documents. This publication addresses a few of these items.

### **Deferrals from Severance Pay**

Historically, there has been little IRS guidance regarding an employer's ability to take salary deferral contributions from severance pay. As a result, some plan sponsors have operated their plans to allow such contributions to be made, especially if the plan uses the "W-2" definition of compensation for contribution purposes, since severance pay is reported on Form W-2. Some plan documents may specifically permit this practice.

In the recently proposed annual additions limit (section 415) rules, the IRS clearly states that deferral contributions may not be made from severance pay. Many view this as a clarification but not a substantive change in the IRS's position. As a result, plan sponsors that currently take deferral contributions from severance pay, should re-examine that practice. Although the proposed effective date for the rules containing this clarification is January 1, 2007, affected plan sponsors may comply with the post-severance compensation changes immediately.

### **Additional Safe Harbor Hardship Withdrawal Reasons**

As discussed in our [March 2005 Pension Analyst](#), the final 401(k) rules provide two new safe harbor hardship withdrawal reasons: for certain funeral/burial expenses and for the repair of certain types of damage to an employee's principal residence.

Some plan documents contain language that automatically allows the use of these two additional hardship reasons. For example, in addition to the four original safe harbor reasons for a hardship withdrawal, a plan document may include "any other event that the IRS recognizes as a safe harbor reason." The existence of this type of provision means that the plan document will not have to be amended to reflect the new safe harbor reasons. However, plan sponsors should avoid offering hardship withdrawals in these situations until the first day of the plan's 2006 plan year, *unless* they are prepared to immediately comply with all the final 401(k) rules. The final 401(k) rules permit early compliance but only with the final rules in their entirety.

## **Deemed Distributions**

Under current rules, a participant who made deferral contributions to a plan but is 0% vested in employer contributions may be deemed to have taken a distribution at termination of employment. This deemed distribution provision allows the plan to use those forfeitures immediately, rather than having to wait until the participant takes an actual distribution, or incurs a five-year break-in-service.

However, the final 401(k) rules require deferral contributions to be taken into account when determining a participant's vesting status and deferral contributions are always 100% vested. As a result, the participant described above would not fall under the "deemed distribution" rule. Thus, the forfeitures for this participant would not be available until he takes an actual distribution or incurs a five-year break-in-service, as specified in the plan document. This new rule applies to participants who terminate employment in plan years beginning on or after January 1, 2006, even if current plan documents have not yet been amended to reflect the change.

Plans that apply a three-year cliff vesting schedule to employer matching contributions and typically have high turnover in employees' first three years of employment, may find that fewer forfeitures will be available to offset incoming employer contributions or pay plan expenses if those terminating employees have a tendency to leave their deferral contributions in these plans. Therefore, these plan sponsors may need to plan for higher out-of-pocket outlays for plan administration, beginning with the 2006 plan year.

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