IRS issues guidance regarding unused paid time off

Who’s affected

This guidance affects sponsors of and participants in qualified defined contribution plans, including 401(k) plans and multiemployer plans. It does not directly address 403(b) plans or governmental 457(b) plans, and IRS spokesmen have provided mixed unofficial messages regarding its applicability to these plans. As a result, sponsors of these types of plans should not take any action without the advice of legal counsel.

Background and summary

In the past, the IRS has concluded in various private letter rulings that unused vacation pay could be contributed to a 401(k) plan. In these rulings, the IRS addressed a ruling request from a specific employer with a specific set of circumstances.

In an effort to promote increased retirement savings, the IRS recently issued two revenue rulings which allow employers with a Paid Time Off (PTO) plan to permit the value of unused paid time off such as accrued sick, vacation and other paid leave, to be contributed to an employer’s qualified retirement plan. Revenue Ruling 2009-31 provides that qualified plans may be amended to permit certain annual contributions of the dollar equivalent of an active employee’s unused PTO. Revenue Ruling 2009-32 states that a qualified plan may allow employees to contribute the dollar equivalent of unused PTO to a retirement plan upon termination of employment. Both revenue rulings discuss:

- That contributions can be either contributed as employer nonelective contributions or as employee pre-tax elective deferrals;
- The impact of contributions on nondiscrimination testing; and
- 415 compensation considerations.

Action and next steps

Plan sponsors that are interested in adopting these plan designs should review the information provided in this publication. They should also discuss the guidance described in this publication with their legal counsel.

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Contribution of unused paid time off

Revenue Rulings 2009-31 and 2009-32 permit employers to allow the value of unused paid time off (PTO) under a PTO plan, to be contributed to an employer’s qualified retirement plan. A PTO plan is a sick and vacation leave plan under which an employee can take paid leave whether or not the employee is sick or injured. Under the revenue rulings, the PTO plan operates on a “use it or lose it” basis and participants cannot carry forward unused PTO into future years.
Plan design issues

Contributing the value of unused PTO time to a retirement plan is an optional plan provision. Both the retirement plan and the PTO plan must contain language that provides for such contributions and employers must amend both plans before the first day of the plan year in which the contributions will be permitted. The retirement plan may provide for the contributions to be either:

- Employer nonelective contributions; or
- Employee pretax elective deferrals.

If an employee does not have the right to elect to receive the amount of unused PTO as income, the dollar equivalent of the unused PTO must be contributed to the plan by the employer as a nonelective contribution. Alternatively, if an employee has the option to receive the amount of unused PTO as a cash payment and the amount is contributed to the plan, the contribution must be made as an elective deferral.

The amounts contributed to the retirement plan as either nonelective contributions or elective deferrals will not be taxable to the participant until distributed from the plan. Distributions of these contributions are subject to the 10% early distribution penalty, unless an exception applies.

Plans that incorporate this plan design will remain qualified plans, as long as they satisfy the testing requirements discussed below.

Testing requirements

Contributions of unused PTO that are aggregated with other contributions made to the plan are subject to:

- Nondiscrimination requirements; and
- Annual cost-of-living limits.

If contributions of unused PTO are contributed as elective deferrals, they are subject to the annual elective deferral limit ($16,500 for 2009 and 2010) and are included in the ADP test (unless the plan is a traditional or Qualified Automatic Contribution Arrangement safe harbor design). In addition, these contributions are subject to the annual additions dollar limit ($49,000 for 2009 and 2010). Since Highly Compensated Employees (HCEs) are more likely to defer unused PTO that could be taken as cash, there could be an adverse impact on the plan’s ADP test. Employers should consider the impact on testing when deciding whether to permit HCEs to contribute unused PTO to their retirement plan.

If an employer contributes the value of unused PTO as employer nonelective contributions, the amount contributed is subject to the annual additions dollar limit. In addition, if HCEs receive nonelective contributions, the plan must perform the general nondiscrimination test, since the safe harbor uniformity requirements will not be satisfied. However, if an employer limits the nonelective contributions to non-highly compensated employees (NHCEs), the plan will satisfy the safe harbor uniformity requirements and no general nondiscrimination test will be needed.

Section 415 compensation considerations

The final section 415 regulations provide that amounts received after an employee’s severance from employment are excluded from “section 415 compensation.” However certain types of payments are considered compensation if they are made by the later of:

- 2½ months after severance from employment; or
- The end of the limitation year that includes the employee’s severance from employment date.

In addition, post-severance regular pay (such as regular, overtime, shift differential pay, commissions, bonuses and other similar compensation) must be counted as section 415 compensation if it is paid within the above timeframe, and the payment would have been paid to the employee before his severance date if he had continued employment with the employer.

However, plans must specify whether other types of post-severance payments are included in section 415 compensation. For example, a plan must specify whether payments of unused accrued sick leave, vacation, or other leave are included, provided the employee would have been able to use the leave if employment had continued, and payment is made within the period specified above. As a result, a plan sponsor that amends its plan to allow terminated employees to contribute unused PTO time, must review the 415 compensation definition in the plan to determine if it must also be amended.

The new guidance also provides examples describing the interaction of contributing unused PTO with the annual additions limits. Plan sponsors must carefully monitor the 100% of compensation limit if a nonelective contribution is made.
in addition to a payment of cash to the participant. *For example, say that a participant terminates at the end of 2009 and has unused PTO valued at $300. When the nonelective contribution design is in place, any unused PTO paid in cash to the participant is considered compensation, but the nonelective contribution is not counted as compensation. Therefore, if $100 is paid in cash to a participant and $200 is contributed to the plan in 2010 as a nonelective contribution, the annual additions limit of 100% of compensation is exceeded.*

However, under the elective deferral contribution design, the total unused PTO, which includes the elective deferral plus the amount paid in cash to the participant, is counted as compensation. As a result, the annual additions limits are not exceeded.

**Outstanding issues**

Permitting the contribution of unused PTO to a retirement plan presents challenges and additional administrative considerations such as the testing and compensation concerns discussed above. In addition, the IRS guidance does not discuss certain issues that remain outstanding.

**Impact of state wage laws**

The rulings do not discuss the impact of state wage laws. Some state laws require the payment of unused PTO upon an employee’s termination of employment and do not permit forfeiture of unused time.

**Application to 403(b) and 457(b) plans**

The guidance in the revenue rulings only addresses contributions made to qualified plans. As previously noted, IRS spokesmen have provided mixed unofficial messages regarding its applicability to 403(b) and 457(b) plans. While these types of plans appear to be very similar to 401(k) plans, there are some subtle differences in the underlying IRS rules that could produce different outcomes. As a result, sponsors of these types of plans should not take any action without the advice of legal counsel.

**Document considerations**

Inclusion of this optional plan provision is a plan design decision that will require consideration and advice from a plan’s legal counsel. A plan sponsor may also want to determine the impact such an amendment might have on their EGTRRA restatement and where the plan stands with respect to the IRS letter determination cycle.

Prudential’s prototype document currently provides the following design options:

- Contributions as elective deferrals. Prudential’s prototype document supports elective deferral contributions of the value of unused PTO.
- Contributions as nonelective contributions. Prudential’s prototype document cannot support this plan design.

Prudential’s volume submitter document currently does not specifically provide for the contribution of unused PTO. If a plan sponsor decides to include this plan design feature, the document will need to be customized.

**Next steps**

Plan sponsors should review the information provided in this publication to determine if they wish to adopt this plan design. In addition, they should identify changes that must be made to both their retirement plan document and their PTO plan document to implement the contribution of unused PTO. If you are interested in adopting the design options provided in the recent IRS guidance, you should contact your Prudential Retirement representative for assistance.