

# Qualified Plan News

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## Helpful Web Links

Department of Labor  
[www.dol.gov/](http://www.dol.gov/)

Taking the Mystery Out of  
Retirement Planning  
[www.dol.gov/ebsa/publications/nearretirement.html](http://www.dol.gov/ebsa/publications/nearretirement.html)

Internal Revenue Service  
[www.irs.gov/](http://www.irs.gov/)

## New IRS Guidance on Automatic Enrollment and Paid Time Off as Plan Contributions

### QPN Highlights

**Action Required:** Clients should be made aware of this new guidance.

- Three new Revenue Rulings provide guidance for expanding existing retirement savings options under a 401(k) or 401(a) plan.
- Revenue Ruling 2009-30 (<http://www.irs.gov/pub/irs-drop/rr-09-30.pdf>) provides guidance for automatic increase of elective deferrals under an automatic contribution arrangement.
- Revenue Ruling 2009-31 (<http://www.irs.gov/pub/irs-drop/rr-09-31.pdf>) provides guidance for plans that permit active employees to contribute unused sick and vacation time to the plan each year.
- Revenue Ruling 2009-32 (<http://www.irs.gov/pub/irs-drop/rr-09-32.pdf>) provides guidance for plans that permit unused vacation and sick time to be contributed to the plan in the year an employee terminates.

for plan participants. These Revenue Rulings provide a degree of clarification regarding three existing options employers have to expand retirement savings under a 401(k) plan or 401(a) plan.

**Automatic Increase of Elective Deferrals** – Revenue Ruling 2009-30 clarifies two points regarding the automatic increase of elective deferrals for employees that are automatically enrolled in a 401(k) plan.

*Uniformity not required for automatic contribution arrangements* - First, under an automatic contribution arrangement that is not intended to satisfy the requirements of an Eligible Automatic Contribution Arrangement (EACA) or a Qualified Automatic Contribution Arrangement (QACA), the elective deferral percentage of an employee that is automatically enrolled may be automatically increased each year. The increase may be based in part on increases in the participant's compensation and may take effect at the time the compensation increase occurs. The example in the ruling describes an automatic increase that is the greater of 1 percent of an employee's base pay or 30 percent of the increase in base pay for the affected employee. Employees would have the option to elect a different deferral

On September 5, 2009, the Internal Revenue Service released the three Revenue Rulings noted above, that are intended to promote increased savings



amount. Although an increase in deferrals that is determined in this manner may result in contribution percentages that are not uniform for all eligible employees, non-uniformity is permissible in this case because the arrangement is not intended to be an EACA or QACA. Note that this approach would not meet the uniformity requirements for a plan that is intended to be an EACA or QACA.

*Date for increasing automatic deferrals* - Second, for a plan that is intended to be an EACA and a QACA, the automatic increase in the elective deferral percentage may be made on a date other than the first day of the plan year, if the increase on that date *applies to all employees* that are automatically enrolled, in the same manner. Further, for a QACA, the deferral percentage in each year must meet the minimum deferral percentage required under the QACA automatic deferral increase requirements. The example presented in the ruling is a calendar year plan that implements pay raises for employees as of April 1<sup>st</sup> of each year. The plan then increases the default deferral percentage for employees who were automatically enrolled (and who made no other affirmative election) on the first pay date after April 1<sup>st</sup>. Under this scenario the plan will not fail to satisfy the qualified percentage requirement (including the uniformity and minimum percentage requirements) of a QACA or the uniformity requirements of an EACA.

**Contributing Unused Sick or Vacation Time Annually for Active Employees** – Revenue Rule 2009-31 clarifies the circumstances under which the dollar value of unused sick or vacation time may be contributed to a 401(k) or 401(a) plan each year, and when those amounts become taxable to the employee.

*Nonelective employer contribution option* - In the first example presented, a paid time off plan (PTO Plan) and a 401(k) or 401(a) plan may provide that the dollar value of each eligible employee's unused sick or vacation time be allocated to each employee as a nonelective employer contribution each year, if that amount is not available to the employee as a cash payment. The plan must contain language to

permit this option. Since each participant will have a different allocation amount **this language is not generally available in prototype plans (e.g., the ING Prototype Plan)**. In addition:

- If any highly compensated employees receive this allocation the plan must perform general nondiscrimination testing to determine if the allocation is discriminatory (this is separate from ADP/ACP testing). This may be avoided by only providing this benefit to non-highly compensated employees;
- The allocation must not cause any employee's account to exceed the annual additions limit under Internal Revenue Code (IRC) section 415(c) (when combined with all other contributions);
- The amount will not be taxable until the employee takes a permissible distribution from the plan (e.g., termination of employment).

*Cash or deferral option* - Alternatively, if the plan includes a 401(k) provision, a PTO Plan and a 401(k) may provide that eligible employees may be permitted to either contribute all or part of the cash value of the unused sick or vacation time as an elective deferral, or receive the same in cash. The plan must contain language permitting the contribution. In addition, the contribution:

- Must be included in the ADP/ACP test (except safe harbor plans);
- Must not exceed the annual deferral limits under IRC 402(g) or the annual additions limits under IRC 415(c);
- Will not be taxable until the employee takes a permissible distribution under the plan (e.g., hardship, age 59 ½). Any amount not contributed to the plan, but paid directly to the employee is taxable in the year it is distributed and the 10% early withdrawal penalty (and related exceptions) applies.

**Contributing Unused Sick or Vacation Time at Termination of Employment** – Under Revenue Ruling 2009-32, the rules for contributing the cash value of unused sick and vacation time to a 401(k) or 401(a) plan are generally the same as those

described above for an annual contribution of these amounts for active employees. The examples presented in the ruling focus, in particular, on the difference in the amount that may be contributed based on the 415 limits when the termination occurs at the end of the limitation year.

When termination occurs at the end of the limitation year the amount paid for unused sick or vacation time will actually flow into the next limitation year. In this case, if elective deferrals are made, compensation is the amount paid plus the elective deferrals; where a nonelective contribution is made, compensation is only the amount actually paid. Therefore, all of the compensation paid for the sick or unused vacation time can be deferred, but only half can be contributed as a nonelective employer contribution.

For example, an employee severs employment December 31, 2009, with \$2,000 in unused PTO. The employer will contribute the PTO amount to the plan (as a nonelective contribution) as of January 31, 2010, to the extent permitted under the 415 limits, and any remaining amount will be paid to the employee. This amount is the only compensation paid to the employee in 2010. The maximum amount the employer can contribute as a nonelective contribution (which is not compensation for plan purposes) would be \$1,000. The employer would then pay the employee \$1,000 as compensation. If the employer were to contribute more than 50% to the plan, the contribution would exceed 100% the employee's compensation and hence would violate the 415 limit.

The potential 415 violation is not an issue if the employee has the choice of receiving the PTO in cash or deferring it to the plan, because the amount subject to the cash or deferral election would be compensation for plan purposes.

**Summary** – The consideration of unused paid time off as a plan contribution is one that the plan sponsor should evaluate carefully before implementation. As noted, document and testing issues may limit practical use of this feature. Also,

Revenue Ruling 2009-32 does not address FICA tax implications or state issues. Generally, nonelective contributions would not be subject to FICA while elective deferrals would be. Some states do not permit forfeiture of unused time and require payment of wages for such time. The nonelective option could be problematic for employers in those states. In light of all the issues, it is important to consult the plan attorney before deciding whether to amend your plan to permit the contribution of unused sick or vacation time.

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