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Retirement PLAN news

Post-severance compensation revisited

For years, there was no guidance on the issue of whether post-severance payments made to employees could be used for qualified plan purposes (i.e., elective deferrals and matching and nonelective employer contributions). As a result, various interpretations existed.

Although the final 2007 Section 415 regulations provided guidance on this issue, some uncertainty remains as to what, if any, post-severance payments may be used for plan purposes. The 415 regulations provide that certain amounts earned during the participant's employment but paid afterward are included in Section 415 compensation for plan purposes. Nonetheless, a common question that arises among plan sponsors, as well as participants, is just what type of post-severance compensation may be used for qualified plan contribution purposes, such as for 401(k) deferrals, and what type cannot be used. This article will parse out the particulars of these rules.

Section 415 compensation amounts

According to the regulations, a post-severance payment is to be included in compensation for qualified plan purposes if it meets all of the following criteria:

- The payment is regular compensation for services performed during an employee's regular working hours or compensation for services performed outside the employee's regular working hours (such as overtime or shift differential pay), a commission, bonus, or other similar payment,
- The payment would have been paid to the employee prior to the severance from employment if the employee had continued working for the employer, and
- The payment is made by the *later of* 2½ months after severance from employment or the end of the limitation year that includes the date of severance from employment with the employer maintaining the plan. So, as a rule of thumb for a plan with a calendar-year Section 415 limitation year, the 2½-month period for an employee who severs employment after October 15 will conclude later than it would for the employee who severs between January 1 and October 15, in which case the relevant date would be December 31.

Example: An employee who is paid by the hour terminates employment on November 30. Her paycheck at that time reflects payments for services through November 15 only. On December 15, the former employee receives a final paycheck for the amount she earned through November 30. This amount must be considered for Section 415 compensation purposes.

Commissions or bonuses earned while working and paid within the specified time period (the later of 2½ months or the end of the limitation year after severance) also must be considered for Section 415 compensation purposes.

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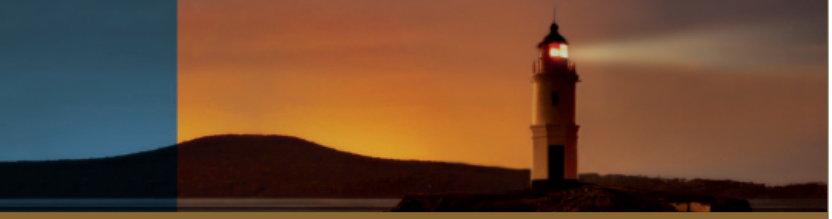

The fiduciary role and *Tibble v. Edison*

Under the Employee Retirement Income Security Act (ERISA), a plan fiduciary has important responsibilities and is subject to specific standards of conduct because he or she is acting on behalf of retirement plan participants and their beneficiaries.

One of the pivotal fiduciary responsibilities under ERISA is the duty to act prudently. Section 404(a)(1)(B) of ERISA provides that a fiduciary must discharge his duties with respect to a plan — "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

This duty requires expertise in a variety of areas, such as investments. Lacking that expertise, a fiduciary will want to hire someone with the necessary professional knowledge to properly carry out the investment and other functions.

The duty of *prudence* also requires that the fiduciary focus on the *process* for making fiduciary decisions. Therefore, it is wise to document decisions and the basis for making those decisions. For instance, when hiring any plan service provider, a fiduciary may want to use a Request for Proposal (RFP) process to survey a number of potential providers, asking for the same information and providing the same requirements. By doing so, the fiduciary can document the decision-making process and make a meaningful comparison and selection.

The fiduciary duty is also ongoing. In *Tibble v. Edison International*,* the U.S. Supreme Court addressed the issue of whether ERISA's six-year statute of limitations barred a claim based on the addition of certain investment choices to the retirement plan's menu. The Supreme Court unanimously held that the Ninth Circuit had erred when it barred the claims because six years had passed since the addition of the choices to the plan.

The Court reasoned that ERISA's fiduciary duty is "derived from the common law of trusts," which provides that a trustee has a continuing duty — separate and apart from the duty to exercise prudence in selecting investments at the outset — to monitor, and remove, imprudent trust investments.

So long as a plaintiff's lawsuit is commenced within six years of the alleged breach of the continuing duty of prudence, the claim is deemed timely. In *Tibble*, though the investments in question were originally added to the fund menu outside the six-year statute of limitations, the fiduciary had allegedly failed to monitor and remove imprudent investments and thereby breached the duty to monitor within the statute of limitations period.

* 575 U.S. ___ (2015)

Post-severance compensation revisited

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Optional compensation amounts

The regulations address additional types of post-severance payments that an employer may choose to include as Section 415 compensation. Keep in mind that the compensation must be for services rendered *before* the employee ceased working to be eligible for qualified plan purposes. Examples include:

- Pay for accrued vacation, sick, and other leave that could have been taken had the employee continued in employment
- Pay differentials for employees who enter qualified military service
- Distributions from unfunded, nonqualified, deferred compensation plans actually paid by the later of 2½ months or the end of the limitation year after severance

Severance pay excluded from the definition of compensation

Post-severance payments other than those just described — including actual *severance pay* — are not includible as compensation for qualified plan purposes, even if they are paid within the specified time frame. Frequently, severance pay is a payment for the release of any legal liability arising from termination of an employee's services. These types of pure severance pay — which are not payments for personal services rendered — are not considered plan compensation.

Section 415 limit and the compensation cap

The regulations coordinate the Section 415 limit with the compensation limit defined under Section 401(a)(17), which is $265,000 for 2016. Here's an example: An employee defers 5% of his salary per payroll on a salary of $360,000. His total deferrals for the year are $18,000 (the maximum allowed in 2016). But when the annual compensation cap under Section 401(a)(17) is applied after year-end, the employee's deferral limit is measured against $265,000, rather than $360,000. Since he did not defer more than the Section 402(g) limit of $18,000, no amount is an "excess deferral" that needs to be returned. However, for testing purposes, the imposition of the Section 401(a)(17) limit will cause the deferral rate to be 6.79%, rather than 5%. (**Note:** There is no "excess deferral" because the plan did not limit elective deferrals to a rate, such as 6%, that was below the recalculated deferral percentage.)

Does an employee have to stop deferring as soon as the compensation cap of $265,000 is reached? No. The 415 regulations provide clarification. The 401(a)(17) compensation cap is an annual limit to be tested after year-end. Thus, if the employee deferred $13,250 on earnings of $265,000 by October and received a bonus in December, the employee could defer on the bonus with a separate deferral election at a higher percentage, even though the $265,000 limit was reached in October. This issue was addressed by the IRS in its electronic newsletter, *Employee Plans News, Fall 2009 Edition.* The article can be found on page four of the publication at *www.irs.gov/pub/irs-tege/fall09.pdf.*

A simple way to avoid this problem, if the plan document allows, is to defer a fixed dollar amount per paycheck rather than a percentage of compensation. Simply take the deferral limit for the year and divide it by the number of payroll periods for the year.

Bankruptcy and retirement plans

In 2005, Congress passed a major revision of the Bankruptcy Code, confirming the protected status of individual retirement accounts (IRAs) and defining the levels of debtor assets that may be sheltered by qualified retirement plans and IRAs.

Bankruptcy law

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), debtors seeking bankruptcy protection whose net monthly income exceeds the median income in their state are required to repay a portion of their debt under Chapter 13. Before BAPCPA, debtors could erase their debt almost entirely under Chapter 7 of the Bankruptcy Code.

Retirement plans excluded from bankruptcy estate

Under BAPCPA, assets held in all qualified plans (such as 401(k), profit sharing, thrift, money purchase, ESOP, and defined benefit plans), 403(b) plans, and state and local government-sponsored 457 plans are expressly excluded from the bankruptcy estate. BAPCPA establishes guidelines for determining the qualified status of retirement plans for bankruptcy purposes. These include a favorable IRS determination letter.

BAPCPA settled an important and long-standing conflict between ERISA and the Bankruptcy Code. Under BAPCPA, participants with loans from a qualified plan must continue making payments. Participants had previously been allowed — and in some cases required — to suspend their plan loan payments.

Protection for IRAs

Although the Supreme Court, in *Rousey v. Jacoway*,* settled the issue of whether IRAs could be excluded from the bankruptcy estate, it did not address the federal bankruptcy law provision regarding the dollar amount that could be excluded. The decision left intact the rule that an IRA may be excluded *only up to an amount reasonably needed* for the individual and spouse to live on in retirement. BAPCPA provided a more specific answer to this question: Assets in traditional and Roth IRAs are protected up to a $1 million limit, *without regard to* rollover amounts.

Note: Under BAPCPA, funds that are rolled over to an IRA from one of the qualified retirement plans previously mentioned are *excluded entirely* from the bankruptcy estate. Because of this favored status, there may once again be good reason for participants to keep rollovers from retirement plans in separate IRAs and not commingle the funds with their personal IRAs. Considering that the maximum annual contribution amount for IRAs has been between $2,000 and the current limit of $5,500, the $1 million limit set by BAPCPA for IRA assets will likely provide sufficient protection for these personal accounts for the foreseeable future.

State law versus federal law

State insolvency laws will still play a role in bankruptcies. Most states require that debtors claim their state's exemptions first, plus any additional exemptions provided under federal laws (such as ERISA). Some states, however, permit debtors to choose between exemptions provided under state laws and those provided under federal laws. In such instances, if state law protects IRA assets in excess of $1 million, an individual may choose to apply the state exemption provision. (This is a decision that should be made with the advice of legal counsel.)

Creditor protection if not in bankruptcy

The laws regarding protection from creditors when an individual has not declared bankruptcy are somewhat different. Assets in qualified plans covered by Title I of ERISA continue to be protected from creditors. In order to be protected by Title I, a plan must benefit a common-law employee. A plan benefiting only a business owner or the owner and spouse is not entitled to the protections of Title I.

One of the special benefits accorded to a qualified retirement plan, such as a 401(k) plan, is the protection from creditors and creditor assignments. Title I, Section 206(d) of ERISA protects a participant's assets from creditors. Creditors may not garnish, levy, or attach the participant's assets in a qualified retirement plan. As stated above, a plan that covers a common-law employee and not just an owner-employee and his or her spouse (or co-owners) is provided this ERISA "Title I protection." Note that the common-law employee may be a child of the owner, provided he or she does not own any interest in the company directly.

If the plan covers one or more common-law employees, it must distribute Summary Plan Descriptions (SPDs) to the plan participants. Plans with an SPD requirement are covered under Title I of ERISA and have protection from creditors.

Note also that assets in IRAs and qualified plans not subject to Title I (such as sole proprietor plans without any common-law employees) may be protected according to a state's laws.

* 544 U.S. 320 (2005)

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RECENT developments

PATH retirement plan provisions

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes (PATH) Act, which contains two retirement plan changes.

Rollovers into a SIMPLE IRA. Rollovers may be made into a SIMPLE IRA from an employer-sponsored retirement plan after the individual has participated in the SIMPLE IRA plan for two years (Section 306). Once this two-year period has been satisfied, a SIMPLE IRA participant may roll funds into the SIMPLE IRA from a qualified plan (such as a 401(k)), a 403(b) plan, or a governmental 457(b) plan, as well as from a traditional individual retirement account (IRA).

Charitable donation IRAs. The allowable exclusion from gross income for qualified charitable donations from IRAs, which had expired December 31, 2014, has been made permanent (Section 112).

How does a charitable donation from an IRA work? An IRA owner who is 70½ or older may make a direct, tax-free donation to a qualified charitable organization of up to $100,000 per year from his or her IRA. The donated amount is also counted toward satisfaction of the required minimum distribution (RMD) for the year.

Keep in mind that this law does not apply to distributions from qualified plans (such as profit sharing and 401(k) plans). Further, if an individual in a qualified plan wishes to roll over funds to an IRA and then make a charitable donation from the IRA, the RMD rules require that the RMD for the year be taken from the qualified plan first and that only amounts distributed above the RMD amount may be rolled into an IRA.

For example, assume an RMD must be distributed in 2016 from a qualified plan. The RMD must be distributed before funds can be rolled from the qualified plan to a new IRA. Since the funds were not in the IRA on the preceding December 31, they are not subject to an RMD in the IRA for 2016. For 2017, a charitable donation of the IRA RMD may be made based on the December 31, 2016, balance.