TRANSAMERICA CENTER FOR RETIREMENT STUDIES®

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TCRS 2009-07: Revenue Rulings 2009-31 and 2009-32 Dealing with the Contribution of the Dollar Equivalent of Unused Paid Time Off to a Profit Sharing Plan

Consistent with the Obama Administration's call for more measures to help working Americans increase their retirement savings, the Internal Revenue Service and Treasury Department (IRS) issued companion Revenue Rulings 2009-31 and 2009-32 to facilitate the conversion of the dollar equivalent of unused leave and vacation into additional retirement plan contributions.

Revenue Ruling 2009-31 provides guidance for the issues described below in 2 situations where the employers maintain a sick and vacation leave paid time off (PTO) plan that is available to all active employees on substantially the same terms and conditions. The PTO plans qualify as bona fide sick and vacation leave plans for purposes of Internal Revenue Code (IRC) section 409A and section 1.409A-1(a)(5) of the Income Tax Regulations. Under the PTO plans, participants may take paid leave without regard to whether the leave is due to illness or incapacity.

Revenue Ruling 2009-32 provides guidance on the same issues described below in 4 situations, but in the context of unused paid time off for terminated employees.

The issues addressed in Revenue Rulings 2009-31 and 2009-32 are:

- Whether the amendment described below to a profit sharing plan requiring or permitting certain contributions of the dollar equivalent of unused paid time off would cause the plan to fail to meet the requirements of IRC section 401(a), and, if applicable, section 401(k); and
- When a participant is required to recognize in gross income contributions of paid time off to the plan and payments of paid time off to the participant.

Under the facts presented in both Revenue Rulings, all the employers maintain a profit sharing plan which includes a 401(k) feature that, prior to the amendments permitting the dollar equivalent of unused paid time off to be contributed to the plans, meets the requirements of IRC section 401(a) and IRC section 401(k). The plans have a calendar plan year and limitation year and the contribution of the dollar equivalent of unused paid time off (when combined with other plan contributions and annual additions) does not exceed the limitations of IRC section 415(c), dealing with the maximum contributions on behalf of a participant under a defined contribution plan, or the limitations of IRC section 401(a)(30), dealing with the limitations on elective deferrals. In addition, the contributions to the plans are made timely by the employers and qualify as a deduction on the employers' tax return for the applicable taxable year.

Revenue Ruling 2009-31

- **Situation 1**

  Under an employer's PTO plan, participants are granted paid time off each January 1, based on their number of years of service. No unused paid time off hours as of December 31 may be carried over to the following year.

  The employer's PTO plan and profit sharing plan were amended, effective January 1, 2009, to allow the dollar equivalent of any unused paid time off as of each December 31 to be forfeited under the PTO plan and contributed to the profit sharing plan as a nonelective employer contribution. The amendment also provides that the dollar equivalent of any unused paid time off remaining after the contribution is made to the profit sharing plan is paid by the employer to the participant by February 28 of the following year.

  Participant A is covered under both the PTO plan and the profit sharing plan. As of December 31, 2009, participant A has $500 of unused paid time off of which only $400 could be contributed to the profit sharing plan because of the limitations of IRC section 415(c). The employer contributes the

$400 to the profit sharing plan which is allocated to participant A's account as of December 31, 2009. The employer pays participant A the remaining $100 in cash on February 28, 2010.

- **Situation 2**

  Under an employer's PTO plan, participants ratably accrue hours of paid time off on a pay period basis starting each January 1. On each December 31, participants may carry over to the following year unused paid time off not to exceed a specified number of hours, referred to as the "carryover limit." The dollar equivalent of any unused paid time off over the carryover limit is paid to participants by February 28 of the following year.

  The employer's PTO plan and profit sharing/401(k) plan were amended effective January 1, 2009, to provide that a participant may elect to reduce all or a part of the dollar equivalent of any unused paid time off that may not be carried over to the following year, and have that amount contributed to the profit sharing/401(k) plan by the employer as an elective contribution for the participant. The profit sharing/401(k) plan does not permit catch-up contributions.

  Participant B is covered under both the PTO plan and the profit sharing/401(k) plan. As of December 31, 2009, participant B has $450 of paid time off in excess of the carryover limit and made a valid and timely election to contribute 60% of that amount to the plan ($270). On February 1, 2010, the employer contributes the $270 to the plan which is allocated to participant B's account as of February 1, 2010, and treated as an elective contribution for the 2010 plan year. The employer pays participant B the remaining $180 on February 1, 2010.

Conclusions

Under Situation 1, the IRS concluded that the amendment does not cause the profit sharing plan to fail to meet the qualification requirements of IRC section 401(a), provided the nonelective contribution, together with other contributions made to the plan, meet the nondiscrimination requirements of IRC section 401(a)(4). Further, if the nondiscrimination requirements of IRC section 401(a)(4) are met, the Revenue Ruling states that the contribution will be includible in participant A's income only when distributed from the plan. The $100 paid to participant A on February 28, 2010 will be taxable income to participant A for 2010.

The Revenue Ruling provides that because the amount of the nonelective contribution made to the profit sharing plan in Situation 1 will vary based on the amount of a participant's unused paid time off, it is unlikely that such a plan will satisfy a design-based safe harbor for nondiscrimination. Rather, testing based on contributions made for individual participants will most likely be required, thus limiting the use of this method to a smaller number of plans.

Plan sponsors are cautioned against proceeding with such an amendment without first consulting with ERISA counsel and their service provider regarding all the implications of treating paid time off as a nonelective contribution.

Under Situation 2, the IRS concluded that the amendment to the profit sharing/401(k) plan does not cause the plan to fail to meet the qualification requirements of IRC section 401(a) and 401(k), provided the elective contribution, together with other contributions and deferrals under the plan, satisfy the nondiscrimination requirements of IRC section 401(k) and the limitation on elective contributions under IRC section 401(a)(30). The $270 elective contribution to the plan will be includible in participant B's income only when distributed. The $180 paid to participant B on February 1, 2010 will be taxable income to participant B for 2010.

Revenue Ruling 2009-32

- **Situation 1**

  Under an employer's PTO plan, participants are granted paid time off each January 1, based on their number of years of service. On each December 31, participants may carry over to the following year unused paid time off not to exceed a specified number of hours (carryover limit). If a participant terminates employment, the dollar equivalent of any unused paid time off remaining at termination of employment is paid to the participant within 60 days after such termination.

  Under the employer's profit sharing/401(k) plan, catch-up contributions are not permitted. The plan provides that IRC section 415 compensation is based only on amounts paid during the limitation year. However, amounts for unused paid time off that are paid by the later of 2½ months after termination of employment or the end of the limitation year that includes severance are treated as plan compensation for IRC section 415 purposes to the extent allowed under IRC section 415.

The profit sharing/401(k) plan and the PTO plan were both amended effective January 1, 2009, to provide that the dollar equivalent of unused paid time off at the time of a participant's termination of employment is forfeited under the PTO plan and contributed to the profit sharing/401(k) plan. The dollar equivalent of any remaining unused paid time off is paid to the participant within 60 days of the termination.

Participant C is covered under both the PTO plan and profit sharing/401(k) plan and terminates employment on October 1, 2009. As of October 1, 2009, participant C has $300 of unused paid time off. The employer contributes the $300 to the profit sharing/401(k) plan for participant C as a nonelective contribution on October 19, 2009, and allocates this amount to participant C's account on October 19, 2009.

- **Situation 2**

  The facts are the same as in Situation 1, except participant C's employment terminates on December 28, 2009, and the remaining unused paid time off is not paid to participant C until 2010. In addition, $150 is contributed to the plan by the employer on January 18, 2010 as a nonelective contribution with the remaining $150 paid to participant C on January 18, 2010.

- **Situation 3**

  Under an employer's PTO plan, participants ratably accrue hours of paid time off on a pay period basis starting each January 1. On each December 31, participants may carry over to the following year unused paid time off up to a specified carryover limit and any unused paid time off over the carryover limit is forfeited. If a participant terminates employment, the dollar equivalent of any remaining unused paid time off is paid to the terminated participant within 60 days of the termination.

  Under the employer's profit sharing/401(k) plan, catch-up contributions are not permitted. The plan provides that contributions to the plan are taken into account for the year in which falls the date the contributions are allocated to participants' accounts. IRC section 415 compensation is based only on amounts actually paid during the year. However, amounts for unused paid time off paid by the later of 2½ months after termination of employment or the end of the limitation year that includes severance are treated as IRC section 415 compensation under the plan.

  The employer amended both the PTO plan and the profit sharing/401(k) plan effective January 1, 2009, to provide that a participant may elect to reduce all or a part of the dollar equivalent of any unused paid time off and have the employer contribute that amount to the plan as an elective contribution for the participant.

  Participant D is covered under both the PTO plan and profit sharing/401(k) plan and terminates employment on October 1, 2009. As of October 1, 2009, participant D has $300 of unused paid time off and has a valid and timely election to have 70% of that amount ($210) contributed to the profit sharing/401(k) plan. On October 19, 2009, the employer contributes the $210 as an elective contribution to the plan for participant D for 2009. The employer pays participant D the remaining $90 on October 19, 2009.

- **Situation 4**

  The facts are the same as in Situation 3, except that participant D's employment terminates on December 28, 2009 and the remaining unused paid time off is not paid to participant D until 2010. In addition, the $210 was not contributed to the plan and allocated to participant D's account until January 18, 2010. The employer pays the remaining $90 to participant D on January 18, 2010.

<u>Conclusions</u>

The IRS concluded that the amendment requiring or permitting certain contributions of the dollar equivalent of unused paid time off to the profit sharing/401(k) plan in all 4 Situations under Revenue Ruling 2009-32 does not cause the plans to fail to meet the requirements of IRC section 401(a) provided the contributions satisfy the nondiscrimination requirements of IRC sections 401(a)(4) and 415(c) and, where applicable, IRC sections 401(k) and 401(a)(30).

In addition, if the applicable plan qualification requirements are satisfied and consistent with the conclusion arrived at in Revenue Ruling 2009-31, the participant does not include in gross income contributions of the dollar equivalent of unused paid time off to the profit sharing/401(k) plan until distributions from the plan are made to the participant. Similarly, the dollar equivalent of unused paid time off paid to the participant is not included in gross income until the taxable year in which paid.

As is the case in Revenue Ruling 2009-31, this Revenue Ruling also provides that because the nonelective contribution made to the profit sharing/401(k) plan in Situations 1 and 2 will vary based on the amount of a participant's unused paid time off, it is unlikely that such plans will satisfy a design-based safe harbor for nondiscrimination. Rather, testing based on contributions made for individual participants will most likely be required, thus limiting the use of this method to a smaller number of plans.

Plan sponsors are cautioned against proceeding with such an amendment without first consulting with ERISA counsel and their service provider regarding all of the implications of treating paid time off as a nonelective contribution.

The Center notes that for most defined contribution plans, cash is the most common form of distribution elected by participants at termination of employment, unless the distribution is rolled over. For this reason, plan sponsors may find it impractical, from a plan design perspective, to allow the dollar equivalent of accumulated paid time off to be contributed to their qualified plan only at the point of termination of employment.