



NAGDCA NOTES

Contribution of Sick and Vacation Pay to Defined Contribution Plans

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Many governmental employers permit employees who are leaving employment to receive accrued but unused sick or vacation time in a lump sum payment. Prior to 2005, the IRS interpretation was that this payment was not eligible to be contributed to a 457(b) deferred compensation plan for two primary reasons. First, tax regulations required that the election to contribute be made by the employee before the compensation was earned. Once sick or vacation pay had accrued, it was "earned" and it was too late to make a contribution election within the requirements of the original 457 regulations. Second, the IRS interpreted the law to require that accrued sick and vacation payment may only be contributed to a plan if the amounts are transferred while the employee retains his employment status. Since most payments for accrued but unused sick and vacation pay are made after the employee leaves employment, the IRS interpreted the law to prohibit the contribution of these payments.

NAGDCA strongly disagreed with these interpretations and urged the IRS to clarify its position. In May of 2005, NAGDCA's persistence produced results.

On May 31, 2005 the IRS issued proposed regulations under IRC Section 415, which limit benefits and contributions under qualified defined benefit and defined contribution plans, SEPs, 403(b) plans, individual 401(h) medical accounts and 419A(d)(1) key employee medical accounts. Section 457 plans are not subject to the 415(c) annual contribution limitations. Section 457(e)(5) and Treasury Reg. 1.457-2(g) do, however, use the participant's compensation within the meaning of Section 415(c)(3) for defining the term "includible compensation" which is used in limiting the amount a participant can defer into a 457(b) plan.

The proposed regulations incorporate existing rules and laws with new guidance on the following:

- Post severance deferrals
- Contributions based on differential pay for employees on qualified military duty
- Minor modifications to the existing 457 regulations

Unless specified elsewhere, the proposed regulations when finalized will formally go into effect for limitation years beginning on or after January 1, 2007. Plans are, however, allowed to immediately adopt the provision allowing sick and vacation leave pay to be deferred into a 457(b) plan within 2 ½ months following severance of employment.

This is one of the most significant changes in the new proposed regulations. It provides an exception to current rules to permit former employees to contribute their post severance pay to 457, 401(k), and 403(b) accounts within 2 ½ months (approximately 75 days) after they terminate employment. Post severance payments include sick, vacation

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and other leave as well as regular pay, commissions, overtime, shift differential pay, and bonuses. It does not include severance payments, parachute payments made to departing executives resulting from corporate takeovers and mergers, or payments from unfunded nonqualified plans.

This exception applies only if the participant would have been paid these amounts if he or she had continued working, or in the case of leave-related payments only if the employee could have used the leave if employment had continued. This portion of the 415 proposed regulations is effective for plan limitations years beginning after January 1, 2005 and taxpayers can rely on this guidance until final regulations are issued. In the case of most 457 plans and 403(b) plans, the limitation year is the calendar year.

Post severance sick and vacation pay can be contributed to a 457(b) plan for up to 2 ½ months after an employee terminates employment, if (1) the agreement to make the deferral is entered into prior to the first of the month the amounts will be paid or made available and (2) such agreement is entered into while the participant is still employed.

Post severance deferrals will count in the contribution limits in the year in which the employee severed service. For example, if the employee severs service in December, 2006 and the payments are actually deferred into the plan in 2007, the deferral is treated as a deferral in 2006. In order to take advantage of the 2007 deferral limits, the participant must actually be employed in 2007.

As a result of this guidance, participants will have greater opportunity to defer these accumulated leave payments than in the past. Instead of being forced to take post severance payments in cash and pay immediate taxes on these amounts, participants will be able to defer these amounts into their former employer's 457(b), 401(k), and 403(b) plans and continue to shelter them until they are to be distributed from the plan.

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*Frueh, Edward A., Treasury Department Issues Proposed Section 415 Regulations:
http://www.truckerhuss.com/articles/view_article.cgi?class=articles&article=_pension_benefits/20050601_treasury_issues_regulations.txt*

IRS Proposed Regulations: <http://www.ustreas.gov/press/releases/reports/13024104.pdf>

NAGDCA Legislative Counsel Update: <http://www.nagdca.org/legislation/story.cfm?id=216>

Pippins, Marty, Highlights of the 415 Regulations: <http://www.irs.gov/pub/irs-tege/415regs.pdf>