

## Media Hype Ignores Limitation of Contributing Vacation Time to Retirement Plan

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Publicity surrounding a 1996 IRS ruling has piqued interest in a program that allows employees to convert unused vacation time into additional benefits under an employer's 401(k)/profit sharing plan.

This program, however, might violate prohibitions against discriminating in favor of highly compensated employees when making contributions to a qualified retirement plan.

In Technical Advice memorandum 9635002, the IRS determined that contribution of unused vacation benefits to a 401(k)/profit sharing plan was not a "cash or deferred" contribution, because an employee could not receive the vacation benefit in cash or any other taxable form. Therefore, the IRS concluded that vacation benefit contributions were not wages subject to FICA tax.

This ruling may offer an attractive planning opportunity for employers in certain limited situations. For example, if an employer currently cashes out unused vacation at the end of each year or wants to provide a current incentive not to use vacation, contributing the cash value of the unused vacation to the retirement plan is cheaper than paying an equivalent amount to employees in cash.

This is because cash compensation is subject to FICA tax and, as the ruling points out, contributions to the retirement plan are not. Therefore, to the extent that an employee's compensation is below the social security wage base, both the employer and the employee will realize a tax savings of 7.65 percent on the amounts contributed to the retirement plan.

Some employers erroneously believe that they can use the ruling to provide additional benefits to executives, because the contribution of vacation benefits to the retirement plan is not subject to the annual \$9,500 limit applicable to 401(k) deferrals.

Contributions to a qualified retirement plan, however, may not discriminate in favor of highly compensated employees. With respect to employer contributions other than 401(k) deferrals and matching contributions, most defined contribution plans satisfy this nondiscrimination requirement using a designbased safe harbor.

In other words, a plan is deemed to provide nondiscriminatory contributions if, under the plan design, contributions are allocated among employees' plan accounts based upon a uniform percentage of each employee's compensation (or based upon a percentage of compensation that incorporates a "permitted disparity").

If the employer's plan does not satisfy a designbased safe harbor, the employer must apply a complex, timeconsuming and potentially costly nondiscrimination test.

If highly compensated employees are allowed to convert unused vacation time into additional retirement benefits, there is a significant risk that the retirement plan will no longer satisfy a designbased safe harbor. Highly compensated employees are generally considered to be those who are fivepercent owners or who earn annual compensation in excess of \$80,000.

If highly compensated employees have more unused vacation or simply elect to convert more to retirement benefits, the uniformity of the employer's contribution is eliminated and the employer must apply the complex nondiscrimination test. If the plan fails this test, it could lose its tax-qualified status.

Although an alternative may be to allow only non-highly compensated employees to contribute vacation benefits to the plan and to provide this contribution strictly as a supplement to the plan's otherwise uniform contributions, many employers will have little interest in this arrangement if executives are excluded.

Before implementing a program of this type, an employer should contact a benefits advisor to determine whether it is appropriate. In addition, employers should review employees' rights to vacation pay with labor counsel to make certain that implementing this program will not violate state labor laws.

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