How Employers Can Allow Employees to Contribute Unused Vacation Time Into a 401(k) Plan

By Jewell Lim Esposito on June 29, 2010

In today's economic climate and the demands of the office, more employees are finding themselves with excess vacation time that they cannot even begin to use. Rather than lose the value of that unused vacation time, employees now might have a way to turn that vacation time into a contribution into their 401(k) plan. In the 1990s, the IRS issued guidance on how an employer can transfer unused vacation or sick pay to employees' 401(k) plans. In September 2009, the IRS re-addressed this subject, issuing **Revenue Ruling 2009-31** and **Revenue Ruling 2009-32** as part of their initiatives to provide tools to help employers and employees save for retirement.

Revenue Ruling 2009-31 deals with employers who maintain a paid time-off (PTO) program which combines vacation and sick leave pay. The revenue ruling addresses two scenarios. The first scenario addresses an employer who maintains a PTO program in which the employees forfeit any unused PTO at the end of the calendar year. In this situation, the employer may amend its 401(k) plan to allow for an employee contribution equal to the value of unused PTO at the end of the calendar year. Here then is an opportunity for the employee to contribute into the plan, without having to come up with any more cash; moreover, this contribution – as with any employee elective deferral – is not treated as current income for income tax purposes. Finally, the employer gets a corresponding deduction for the same calendar year.

The second scenario has a PTO plan which provides for a limited carryover and an automatic cash-out of unused PTO that exceeds the carryover allowance. If an employee has three weeks of PTO time and the maximum carry-over is one week, the employer cashes out the remaining two weeks to the employee. In this scenario, the employer amends its 401(k) plan to allow employees to elect to receive the PTO cash-out or to contribute the PTO cash-out to the 401(k) plan in the following February. The employee election is treated as a typical cash or deferred election under Section 401(i) of the code. The deferral again is spared current income taxation, and the employer gets its deduction either way.

Revenue Ruling 2009-32 addresses contributions of PTO time following termination of employment. In this ruling, both employer contributions automatically pour over to the 401(k) plan following termination. Like **Revenue Ruling 2009-31**, automatic pour-overs to the 401(k) are considered employee contributions, which remain subject to regular Section 401(k) contribution limits. Note that neither the rulings nor the IRS states whether or not the concept will work with Section 403(b) plans. As 403(b) plans are starting to act and operate much like 401(k) plans, it seems likely that a 403(b) plan could provide for the same time of contribution of unused PTO, again subject to contribution limits. Employers might want to consider adding this type of design feature, particularly if their employees are unable to use all PTO allocated to them.