

Post-Termination of Employment Payments: Which Amounts are Considered 401(k) Plan Compensation?

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PRACTICES Employee Benefits and Executive Compensation

When an employee terminates employment, the determination as to whether certain post-termination payments should be included in 401(k) plan compensation for purposes of calculating participant deferrals and employer contributions (“**Plan Compensation**”) is an often-confused topic. The confusion may stem from the fact that many of the terms frequently used to describe payments made after an employee’s termination are frustratingly similar. Thus, even if a plan sponsor or administrator refers to the definition of Plan Compensation included in the plan document, it may be difficult to determine which post-termination payments should be included in Plan Compensation and which ones should be excluded.

In general, pure severance pay (“**Severance Pay**”) is not considered Plan Compensation, but post-severance payments related to compensation earned and accrued during employment (“**Post-Severance Pay**”) are Plan Compensation. Below is a summary of these pay components intended to clarify and highlight the distinctions between each.

What is Severance Pay?

Severance Pay are payments that result solely due to an employment termination. As the DOL noted [here](#), Severance Pay is pay “granted to employees upon termination [and] it is usually based on length of employment for which an employee is eligible upon termination.” For this purpose, an employer generally will either enter into a severance agreement upon the employee’s termination or apply its applicable company severance plan provisions to provide a stated amount of severance based on the employee’s length of service. As noted above, Severance Pay is generally not considered Plan Compensation under IRS rules because it is not considered payment for services rendered if paid after an individual is no longer an employee, and it is paid as a result of the employee’s termination of employment.

What is Post-Severance Pay?

Conversely, Post-Severance Pay may be included in Plan Compensation because it is pay that the employee would have received if he or she was not terminated by the employer. Examples of Post-Severance Pay include earned and unused paid time off, bonuses, or commissions that an employee is entitled to receive which get paid following a termination of employment, and scheduled deferred compensation payments. The IRS defines regular Post-Severance Pay as follows:

- Compensation paid by the later of: (a) 2-1/2 months after an employee’s termination of employment; or (b) the end of the limitation year (usually the calendar year) in which the employee terminates employment provided that:
 1. the payment is compensation for services during the employee’s regular working hours (including overtime, bonuses, and commissions); and

2. the payment would have been paid to the employee prior to a termination of employment if the employee had remained employed.
- In addition to regular Post-Severance Pay, the IRS also defines two other types of payments to qualify as Post-Severance Pay if paid by the later of 2-1/2 months after an employee's termination of employment or the end of the limitation year in which the employee terminates employment:
 1. payments for unused accrued bona fide sick, vacation, or other leave, but only if the employee would have been able to use the leave if his employment had continued, and
 2. payments received under a nonqualified unfunded deferred compensation plan, but only if the payment would have been paid to the employee at the same time if the employee had continued in employment with the employer and only to the extent that the payment is includible in the employee's gross income.

Importance of Reviewing the Plan Document

Some plan documents exclude all post-termination payments, including Post-Severance Pay from compensation, so it's always important to review the plan's definition of Plan Compensation to determine which elements of compensation are included and excluded.

In summary, the key determination as to whether payments made after a termination of employment may be considered Plan Compensation ultimately depends on whether the pay constitutes (i) additional severance payments triggered solely due to such termination or (ii) Post-Severance Pay that is paid to the employee for services performed prior to the termination. It is always important to consult the plan document to determine which compensation components are included and excluded in the definition of Plan Compensation.

Plan sponsors and administrators that are unsure whether certain post-termination payments are included in Plan Compensation should consult legal counsel. Additionally, if it is determined that any post-termination payments have been erroneously included or excluded, plan sponsors should consult counsel to determine what IRS voluntary correction options may be available.