

# Legal Alert: SECTION 415 FINAL REGULATIONS CLARIFY RULES

April 10, 2007

On April 5, 2007, the Internal Revenue Service (IRS) issued [final regulations under section 415](#) of the Internal Revenue Code (the Code). The final rules adopt most of the provisions in the May 2005 proposed regulations, with a few notable exceptions, and add provisions reflecting amendments to Code section 415 made by the Pension Protection Act of 2006 (PPA). This Legal Alert highlights the most significant provisions of the final regulations and notes the significant changes to the 2005 proposed regulations made by the final rules.

## Background and Overview

Section 415 establishes limits on the annual benefits that may be provided under a qualified defined benefit plan and on contributions and other annual additions to a qualified defined contribution plan. The section 415 limits also apply to tax-sheltered annuities under section 403(b), simplified employee pensions (SEPs), certain retiree medical accounts linked to qualified retirement plans, and key employee medical benefit accounts. The changes to section 415 made by the final rules are particularly important since the definition of compensation that is used for purposes of section 415 is also used for a number of other purposes under the Code, including determining the limits on deductions for contributions to a plan under section 404, determining whether an employee is highly compensated within the meaning of section 414(q), and determining nondiscriminatory compensation for purposes of applying the ADP, ACP, and other nondiscrimination tests.

Prior to the issuance of the 2005 proposed regulations, comprehensive section 415 regulations were last issued in 1981. For more than twenty-five years, updates to the 1981 regulations to reflect statutory and other changes were incorporated in a series of revenue rulings and notices. The proposed regulations both consolidated all of the section 415 rules in updated regulations and reflected certain statutory changes not previously addressed in IRS guidance. The final rules adopt the 2005 proposed regulations with certain changes, including changes made by the PPA. Most notably, the final rules:

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- Incorporate the rule from the proposed regulations limiting the types of compensation paid after severance from employment that may be taken into account in applying the limits, but extend the period during which this post-employment compensation can be recognized, and allow certain payments from nonqualified arrangements both during employment and post-employment to be treated as compensation;
- Add an exception to the post-employment payment timing rule for disability payments;
- Require coordination of the limits under Code sections 401(a)(17) and 415, but provide for grandfathering of the pre-2005 rules regarding the interaction between the rules of these sections;
- Withdraw the multiple annuity starting date rules of the proposed regulations for further consideration;
- Modify certain rules relating to the incorporation of the section 415 limits into a plan by reference; and
- Change the rules for calculating a participant's average compensation for his or her three highest-paid years of service.

## Highlights of the Final Rules

***Post-Employment Compensation.*** Generally, under the proposed regulations, amounts received following severance from employment could not be considered compensation for purposes of section 415. The IRS had proposed, however, that section 415 compensation could include compensation paid within 2 1/2 months after termination of employment, but only if those amounts would have been paid if the participant had continued in employment or if the payments were for bona fide sick, vacation, or other leave that the employee would have been able to use if employment had continued. The final regulations retain these restrictions on the types of post-employment compensation that can be taken into account as compensation for purposes of section 415. The final rules also, however, extend the permissible payment period for post-employment compensation from 2 1/2 months after severance from employment to the later of two and a half months after severance or the end of the limitation year that includes the date of severance from

employment. With respect to bona fide leave payments, the final regulations add the requirement that the plan explicitly provide that such post-severance payments are included in compensation. The final regulations also permit payments made post-employment from a nonqualified unfunded deferred compensation plan to be treated as compensation, if the payments would have been made at the same time if the employee had continued employment and the payments are includable in gross income.

***Military Continuation and Disability Pay.*** Like the proposed regulations, the final rules provide that post-employment payments for qualified military service under section 414(u)(1) may be considered compensation for section 415 purposes, regardless of the timing of the payments, to the extent that the payments do not exceed the pay that the employee would have received if he or she had remained actively employed, rather than entering qualified military service. The final regulations add another exception for compensation paid to a permanently and totally disabled participant. These “deemed disability” payments may be considered compensation for section 415 purposes, regardless of the timing of payment, if: (1) the plan provides for the continuance of contributions for disabled participants on a nondiscriminatory basis, as determined under the regulations; (2) the plan states that the deemed disability compensation is treated as compensation for section 415 purposes; and (3) contributions made with respect to the deemed disability amounts treated as compensation are nonforfeitable.

***Interaction between sections 415 and 401(a)(17).*** The proposed regulations provided that the definition of compensation used in determining the average compensation for a participant’s highest-paid three years under a defined benefit plan cannot reflect compensation in excess of the Code section 401(a)(17) limit. Many practitioners viewed this position as a departure from the generally accepted rule that section 415 compensation was not subject to the section 401(a)(17) compensation limit. While the IRS chose to retain the rule from the proposed regulations, the final rules “grandfather” benefits accrued or payable under a plan as of the end of the limitation year immediately prior to the effective date of the final regulations. These benefits may be based on compensation in excess of the section 401(a)(17) compensation limit to the extent consistent with plan provisions that were adopted and in effect before April 5, 2007.

***Multiple Annuity Starting Dates.*** The IRS had proposed complex rules for determining whether the section 415(b) annual benefit limit has been reached for the current year if a participant has received more than one distribution subject to the limit in the same year. These rules would have applied, for example, (1) in the case of distributions under two or more aggregated plans, if payment commenced under one plan earlier than the other; (2) if a participant was able to commence benefits but continued to receive current accruals;

or (3) if a stream of benefit payments was modified as a result of issuance of a QDRO or a new benefit election. In response to concerns from commentators, the IRS withdrew the proposed rules for multiple annuity starting dates and indicated that a new proposal would be developed to address these situations. In the interim, the final regulations provide that if a participant has multiple annuity starting dates, the limitations of section 415 must be satisfied as of each of the annuity starting dates, taking into account all benefits that have been or will be paid at all of the annuity starting dates.

***Incorporation by Reference Rules.*** Many defined benefit plans incorporate the dollar limitation of section 415(b) and any annual cost-of-living adjustments to the dollar limit under section 415(d) by reference. The proposed regulations specified that, for plans that incorporate the annual increases by reference, the annual increases do not apply in limitation years beginning after the annuity starting date if a participant has commenced receiving benefits unless the plan specifies that the annual increases will apply to these participants. A commentator pointed out that this provision would modify the default rule under the 1981 final regulations, which provided that annual cost-of-living adjustments are not made after a participant's *separation from service* unless the plan provides otherwise. In response, the Service modified the final regulations to retain the 1981 rule and to provide that annual increases that become effective after a participant's severance from employment (or, if earlier, after the annuity starting date in the case of a participant who has commenced receiving benefits) are not applicable to participants unless the plan so provides.

***Calculation of Average Compensation.*** Generally, the annual benefit provided under a defined benefit plan must not exceed the lesser of \$160,000 (as adjusted) or 100 percent of the participant's average annual compensation for the participant's three highest-paid years of service. The proposed regulations would have required that the calculation of the high three-year average compensation be based on years in which the participant was an active participant in the plan, rather than all of participant's years of service, including pre-participation years. The PPA eliminated the "active participation" requirement for purposes of determining average compensation for years beginning after December 31, 2005. Accordingly, the active participation requirement is not included in the final rules.

***Treatment of Partial QJSA benefits.*** Section 415(b)(2)(B) provides that the survivor annuity portion of any qualified joint and survivor annuity (QJSA) is not taken into account for purposes of the section 415(b) annual limitation on benefits. Prior to the issuance of the proposed regulations, this exception did not apply to any portion of a benefit that was paid partially in the form of a QJSA and partially as a lump sum (or some other form of payment). Like the proposed regulations, the final regulations extend the section 415(b)(2)(B) exception to the portion of such benefits paid in the form of a QJSA.

***Correction of Section 415 Excess.*** The 1981 final regulations provided for several correction methods for excess annual additions, including the maintenance of suspense accounts. The proposed regulations removed these correction methods from the regulations, and, in the 2006 update of the revenue procedure setting forth the Employee Plans Compliance Resolution System (EPCRS), the IRS asked for comments as to whether the correction methods should be provided as options under EPCRS. The final regulations reflect the same approach; in the preamble, the Service noted that, pending further guidance, the former correction methods may be implemented as a self-correction under EPCRS if the rules of section 9 of Rev. Proc. 2006-27 are met.

***Pension Protection Act Changes.*** The final regulations reflect modifications to section 415 made under PPA, including changes to the interest rate assumptions used for converting certain forms of benefit to a straight life annuity and the elimination of the active participation requirement in determining a participant's high-three years of service (see *Calculation of Average Compensation*, above).

### **Additional Changes to the Final Rules**

In addition, the final rules:

- Simplify the rules regarding adjustments to the section 415(b) limit for forms of benefit other than a straight life annuity that are not subject to the minimum present value standards of section 417(e)(3).
- Modify the proposed regulations to provide adjustments for calculating the high three-year average compensation under section 415(b) for an employee who is rehired after terminating employment.
- Incorporate the method specified in the proposed regulations for adjusting the defined benefit dollar limitation in the case of an early or late commencement of benefits.
- Clarify and modify the section 415(f) plan aggregation rules for purposes of transferred benefits and limit the extent to which benefits under plans maintained by a predecessor employer must be aggregated.
- Provide that if a defined benefit plan is terminated without sufficient assets for the payment of accrued benefits, all other defined benefit plans maintained by

the employer that maintained the terminated plan are required to take into account the benefits that are actually provided under the terminated plan for section 415 purposes.

- Specify that payments made to restore losses to a defined contribution plan resulting from actions by a fiduciary that create a reasonable risk of liability under federal or state law do not give rise to an annual addition for any limitation year.
- Modify the rules for determining when a contribution to a plan made by a tax-exempt employer is taken into account for a limitation year pursuant to section 415(c).
- Clarify that amounts includable in income under Code section 409A or Code section 457(f) (or that are otherwise constructively received by the employee) generally are considered compensation for section 415 purposes.
- Clarify the treatment of compensation paid to a non-resident alien for purposes of section 415.
- Add rules for the disqualification of a plan where the aggregation of an individual medical benefit account or a post-retirement medical benefit account for a key employee with a qualified defined contribution plan causes the annual additions limit of section 415(c) to be exceeded.
- Add rules providing that if a defined contribution plan is terminated effective as of a date other than the last day of the plan's limitation year, the plan is deemed to have been amended to change its limitation year and the section 415(c) annual additions dollar limit must be pro-rated under rules for short limitation years.
- Clarify the section 457 catch-up rules and change the 457 rules to reflect changes to the definition of "dependent" in Code section 152.
- Reflect a number rules for governmental and church plans, defined benefit plans with employee contributions, and other types of plans to which special rules apply under section 415.

The updates in the final rules include a new numbering scheme for the section 415 regulations and corresponding changes to regulations under Code sections 401(k), 414(s), 416, and other rules to reflect revised cross-references or other similar changes.

## Effective Dates

Except as otherwise provided above, the final regulations apply for limitation years beginning on or after July 1, 2007. Most calendar year plans will begin applying the rules as of January 1, 2008. However, for purposes of determining compensation applicable to nondiscrimination testing under regulation section 1.401(k)-(e)(8), the rules apply to compensation paid in plan years beginning on or after July 1, 2007, and the amendment to the definition of dependent as it relates to section 457 applies to taxable years beginning on or after December 31, 2001. Certain changes made pursuant to the PPA are effective as of the dates the relevant rules are effective under PPA. Plans will generally need to be amended to comply with the final regulations by the deadline for filing the employer's income tax return (including extensions) for the 2008 taxable year.



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