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A legal update from Dechert's Employee Benefits and Executive Compensation Group

IRS Issues Final Regulations Under Section 415 of Internal Revenue Code

Recently, the Internal Revenue Service (the "IRS") issued final, comprehensive regulations under Section 415 of the Internal Revenue Code (the "Code"). Section 415 was added to the Code in 1974, as a part of the Employee Retirement Income Security Act of 1974 ("ERISA"), and the first comprehensive regulations under Section 415 were issued in 1981. Since then, there have been many statutory changes to Section 415. With this in mind, the IRS issued proposed regulations under Section 415 in 2005. The final regulations are based on the proposed regulations but have a few changes and add a number of examples.

The Importance of Section 415

Section 415 sets limits on benefits and contributions for tax-qualified retirement plans. The annual benefit of a participant under a qualified defined benefit plan may not exceed the lesser of $160,000 or 100 %of the participant's average annual compensation for his or her high three years. The $160,000 dollar limit is reduced to the extent that the payment of the participant's benefit starts before age 62, and is increased to the extent that the payment of the participant's benefit starts after age 65.

The annual additions to a participant's account under a qualified defined contribution plan may not exceed the lesser of $40,000 or 100% of the participant's compensation. The $160,000/$40,000 dollar limits are increased periodically for cost-of-living changes (the limits are $180,000 and $45,000 for 2007).

Updates for Statutory Changes

The final regulations include the following to reflect statutory changes that have been made to Section 415 since 1981:

- the current statutory limit on a participant's annual benefit under a qualified defined benefit plan, namely, the lesser of $160,000, as increased for cost-of-living changes (called the "defined benefit dollar limit" below; as indicated above this limit is $180,000 for 2007) or 100% of compensation for the participant's high three years (called the "defined benefit compensation limit" below);

- the current statutory limit on annual additions to a participant's account under a qualified defined contribution plan, namely, the lesser of $40,000, as increased for cost-of-living changes (called the "defined contribution dollar limit" below; as indicated above this limit is $45,000 for 2007) or 100% of compensation;

- the changes to the rules for benefit adjustments under a qualified defined benefit plan when payment of a participant's benefit starts before age 62 or after age 65;

- the elimination of the active participation requirement in determining a participant's average annual compensation over his or her high three years;

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- the actuarial assumptions to be utilized (including certain specified interest rate assumptions) and other specific parameters to follow when a benefit payable under a qualified defined benefit plan is adjusted to be an actuarially equivalent straight life annuity for purposes of applying the Section 415 limit on benefits;

- the rules for the reduction of the defined benefit plan dollar limit to the extent a participant has less than 10 years of participation;

- the rules under which the Code Section 401(a)(17) compensation limit ($225,000, as increased for cost-of-living changes for 2007) interacts with the

- Section 415 limit on the benefits under a qualified defined benefit plan;

- the repeal of the Section 415(e) combined benefit/contribution limit on qualified defined benefit and defined contribution plans;

- the inclusion in Section 415 compensation of pre-tax contributions (i.e., contributions not included in gross income) made under certain employer plans, such as a 401(k) plan, Code Section 125 cafeteria plan and Code Section 132(f)(4) qualified transportation fringe benefit plan; and

- the rounding and base period rules for annual cost-of-living adjustments under Section 415(d).

Rules for Qualified Defined Benefit Plans

The final regulations retain the rule from the proposed regulations under which, for any participant in a qualified defined benefit plan, each of the following must meet the Section 415 limit on benefits:

- the participant's annual benefit which becomes payable,

- the participant's accrued benefit (without regard to whether the accrued benefit is vested), and

- any benefit payments made to the participant from an annuity contract purchased and distributed to the participant.

The proposed regulations had extensive new rules for dealing with multiple annuity starting dates. Multiple annuity starting dates arise, for example, when a participant's benefit payments have started under a plan which is aggregated for purposes of Section 415 with another plan under which the participant is currently earning benefit accruals, or when a new distribution election becomes effective for benefit payments which have already started.

Due to their complexity, the IRS withdrew those proposed rules for further study, although the final regulations require a participant's annual benefit which becomes payable to meet the Section 415 limit as of each annuity starting date, taking into account the benefit that has been or will be provided to the participant at all of the annuity starting dates. In determining the annual benefit of a participant as of a particular annuity starting date, the plan must actuarially adjust past and future benefit payments which have started or will start at the other annuity starting dates.

When determining a participant's average annual compensation for his or her high three years, the years to be used are the three consecutive calendar years during which the participant received the highest aggregate compensation. If the participant was not employed during at least three consecutive calendar years, the participant's average compensation is determined by taking the annual average of the participant's compensation over his or her longest consecutive period of service (including fractions of years, but not less than one year).

As indicated earlier, the final regulations removed a rule in the prior regulations which had restricted the compensation which a plan could consider to the compensation earned during periods of participation in the plan. The final regulations contain several new rules which apply in determining a participant's average annual compensation over his or her high three years when the participant is rehired.

The final regulations (like the proposed regulations) clarify that a plan cannot take into account compensation, in any year, in excess of the dollar limit under Code Section 401(a)(17) for that year (this limit is $225,000 in 2007), when determining a participant's high three year average annual compensation. However, for a plan that had provided otherwise, the final regulations provide a grandfather rule.

If a participant's benefit under a qualified defined benefit plan is payable in a form other than a straight life annuity, the final regulations provide new actuarial assumptions (including certain interest rate assumptions) to be used to convert the other form of benefit payment to an actuarially straight life annuity, and the annual amount paid under this straight life annuity is used to determine whether the participant's annual benefit exceeds the Section 415 limit. Also, the final regulations contain extensive new rules for adjusting the defined benefit dollar limit when the benefit payments start before age 62 or after age 65.

The Code has long provided that, when a participant's benefit under a qualified defined benefit plan is paid in the form of a qualified joint and survivor annuity (a "QJSA"), the survivor annuity portion of the QJSA is not taken into account when determining if the participant's benefit payments meet the Section 415 limit. The final regulations reflect this rule, and in addition, clarify that, if the participant's benefit is partially paid as a QJSA (e.g., the participant receives a QJSA and a partial lump sum), the survivor annuity portion of the QJSA part of the benefit payments is not taken into account for Section 415 purposes. On the other hand, the final regulations clarify that social security supplements are included in a participant's annual benefit for Section 415 purposes.

The final regulations allow a qualified defined benefit plan to incorporate by reference the Section 415 limit on benefits, including limit increases made under Section 415(d) for cost-of-living changes. The regulations provide that, when the plan has incorporated the 415 limit and 415(d) increases by reference, any benefit increase which is attributable to such limit increases, and becomes effective after a participant's severance from employment (or, if earlier, the participant's annuity starting date for his or her benefit payments), does not apply to the participant, unless the plan provides for such application.

Rules for Qualified Defined Contribution Plans

The final regulations contain three significant rule changes pertaining to qualified defined contribution plans. Under the first rule, a restorative payment is not treated as an annual addition when allocated to participants. A "restorative payment" is a contribution which is made to the plan by the employer to restore some or all of the plan's losses caused by the action of a fiduciary, when such action created a reasonable risk of liability for breach of fiduciary duty under ERISA or any other applicable federal or state law, and with respect to which plan participants who are similarly situated are treated the same.

Under the second rule, if the employer or an employee transfers assets to a plan, for consideration from the plan which is less than fair market value, the excess of the asset's value over the consideration is an annual addition (and the transfer may be a prohibited transaction under Code Section 4975). Finally, an amount allocated to a participant's account, which under the terms of the plan is contingent on the satisfaction of a condition, is not treated as an allocation until the condition is satisfied.

The provisions in the prior regulations containing correction methods for excess annual additions have been eliminated. However, these methods are generally permitted to be used to correct excess annual additions under the Employee Plans Compliance Resolution System ("EPCRS") in IRS Rev. Proc. 2006-27, including the self-correction feature of the EPCRS.

Change to Definition of Compensation

One important change made by the final regulations to the prior regulations are the rules for determining when post-separation pay is included in "compensation," as used to apply the Section 415 limits.

Under these rules, "compensation" does not include amounts received following severance from employment. However, there is an exception for certain payments made by the later of 2 1/2 months following severance or the end of the limitation year in which the severance occurs. The types of payments subject to the exception are:

- regular salary and wages, and overtime, shift differential, commissions, bonuses and similar pay, that would have been paid if the employee had continued in employment,
- if the plan so provides, payments of unused accrued bona fide sick, vacation, or other leave which could have been used if the employee had continued in employment, and
- if the plan so provides, a taxable payment from a nonqualified plan of deferred compensation plan, if the payment would have been made to the employee at the same time if employment had continued.

Payments made to a participant performing qualified military service, or in certain cases to a permanently and totally disabled participant, will be includible in "compensation," even if paid following termination of employment and not by the 2 1/2 month/year end deadline, but only if the plan provides for such inclusion. No other post-severance payments are included in compensation, regardless of when made.

In connection with these rules, the IRS is amending the Code Section 401(k) regulations to specifically incorporate the Section 415 definition of "compensation". This means that elective deferrals from a 401(k) plan may not be made with respect to post-severance pay, unless the pay falls within the 2 1/2 month/year-end exception.

The final regulations include in "compensation" amounts included in an employee's gross income under Code Section 409A or under the constructive receipt rules. The final regulations clarify that a plan cannot take compensation in excess of the Section 401(a)(17) limit into account.

Cost-of-Living Adjustments

The final regulations retain a safe harbor from the proposed regulations, and provide two new safe harbors, under which cost-of-living increases made to benefit payments under a qualified defined benefit plan are automatically treated as meeting the Section 415 limit on benefits.

Other Rules

The final regulations include some new rules regarding aggregating employers and qualified retirement plans (including when a group of employers breaks up), predecessor employers and their plans, the disqualification of plans and trusts, rollovers and transferred benefits, plan terminations, and the definition of the limitation year. Under one such rule, if a qualified defined contribution plan is terminated on a date which is not the last day of the limitation year, the plan is automatically treated as having amended its limitation year to be a short limitation year, and the defined contribution dollar limit on annual additions must be prorated. Because of the complexity of the new rules, employers which belong to a controlled group, or which have, or maintain a plan of, a predecessor employer, should review these rules carefully, so that they can aggregate plans correctly for Section 415 purposes.

Effective Dates and Amendments

The final regulations apply to limitation years beginning on or after July 1, 2007, with certain exceptions. The revision to the 401(k) regulations relating to post-severance compensation applies for plan years beginning on or after July 1, 2007. Employers may elect to apply the post-severance compensation rules to qualified retirement plans (including 401(k) plans) in earlier limitation years.

Qualified retirement plans generally must be amended to comply with the final regulations by the deadline for filing the employer's tax return (including extensions) for the tax year which includes the effective date of the final regulations (e.g., by the due date (including extensions) for the tax year ending December 31, 2008 for a plan with a calendar year limitation year).

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Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

Robert W. Ballenger
Philadelphia
+1 215 994 2208
robert.ballenger@dechert.com

Stanley D. Baum
New York
+1 212 698 3838
stanley.baum@dechert.com

Richard D. Belford
New York
+1 212 698 3607
richard.belford@dechert.com

Susan M. Camillo
Boston
+1 617 728 7125
susan.camillo@dechert.com

David F. Jones (Chair)
Philadelphia
+1 215 994 2822
david.jones@dechert.com

Paul S. Kimbol
Philadelphia
+1 215 994 2603
paul.kimbol@dechert.com

Melissa K. Ostrower
New York
+1 212 698 3624
melissa.ostrower@dechert.com

Abigail B. Pancoast
Philadelphia
+1 215 994 2574
abigail.pancoast@dechert.com

Drew A. Picciafoco
Boston
+1 617 728 7109
drew.picciafoco@dechert.com

Beth L. Rubin
Philadelphia
+1 215 994 2535
beth.rubin@dechert.com

Stephen W. Skonieczny
New York
+1 212 698 3524
stephen.skonieczny@dechert.com

Frank B. Tripodi
New York
+1 212 698 3871
frank.tripodi@dechert.com

Jessica R. Zaklad
Philadelphia
+1 215 994 2175
jessica.zaklad@dechert.com

Kathleen Ziga
Philadelphia
+1 215 994 2674
kathleen.ziga@dechert.com

Dechert LLP

www.dechert.com

U.S.

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