

Client Alert

A report
for clients
and friends
of the Firm August 2007

IRS Issues Final Regulations Under Code Section 415

The Internal Revenue Service (the "IRS") recently issued final regulations under Section 415 of the Internal Revenue Code of 1986, as amended (the "Code"), regarding limitations on benefit accruals and contributions to qualified plans.

The final regulations incorporate statutory changes made to Section 415 of the Code ("Section 415") and related provisions since 1981, including modifications made by the Pension Protection Act of 2006 (the "PPA"), and generally restate the existing regulations under Section 415. The final regulations are generally effective for plan years beginning on or after July 1, 2007, but for plans with a calendar year limitation year, the final regulations apply on or after January 1, 2008.

Limitations on Qualified Plans

Section 415 limits the amount of benefits that can be provided under qualified pension plans. These limits are indexed for inflation. For 2007, a defined benefit plan cannot provide for the payment of benefits which exceed the lesser of \$180,000 or 100% of the participant's average compensation for the highest three consecutive years of service, *i.e.*, the three consecutive years during which the participant had the greatest aggregate compensation. The amount of annual additions (*i.e.*, employer contributions, employee contributions and forfeitures) that can be made to a defined contribution plan for 2007 is limited to the lesser of \$45,000 or 100% of a participant's compensation for the limitation year.

Changes to the Definition of Compensation

Post-Separation Payments

Payments made after an employee's separation from employment are generally not "compensation" for purposes of Section 415. However, the final regulations provide that post-separation payments are treated as compensation if such payments were paid within the later of 2½ months after the termination date or the end of the limitation year in which employment is terminated. Payments subject to this exception include: (i) salary, wages, overtime, shift differential, commissions, bonuses and similar amounts earned pre-separation that would have been payable if the employee continued employment; (ii) accrued bona fide sick, vacation, and other leave that would have been usable if the employee continued employment and the plan specifies that such payments are included in compensation; and (iii) post-separation payments from a nonqualified unfunded deferred compensation plan provided the deferred compensation payments would have been made at the same time if the employee had continued employment and the plan specifies that such payments are included in compensation and only to the extent such payment is includible in the employee's gross income.

If the plan so provides, compensation may also include payments to an individual who is in qualified military service or who is permanently and totally disabled. These payments may be included as compensation even if they are paid after the time frame described above, as long as certain conditions are met.

Compensation Limit

The final regulations require that the amount of compensation used to determine the limitations under Section 415 be limited by Section 401(a)(17) of the Code (for 2007, the inflation-adjusted amount is

\$225,000). Under a grandfather provision in the final regulations, compensation in excess of the Section 401(a)(17) limit will nonetheless satisfy the annual benefit limitations for benefits accrued or payable under the plan at the end of the limitation year that is immediately prior to the effective date of the regulations as long as the relevant plan provisions were adopted and in effect before April 5, 2007.

Treatment of Nonresident Aliens

The rules affecting employees who are nonresident aliens have been liberalized such that amounts paid as compensation for services will not fail to be treated as “compensation” for purposes of Section 415 merely because those amounts are not includible in gross income on account of the location in which the services are performed. The preamble to the final regulations notes that other requirements relating to an employee’s participation in a qualified plan have not been modified, including the rules relating to which a controlled entity is entitled to a deduction for employee contributions.

Rules Affecting Defined Benefit Plans

Highest Three Active Participation

To determine a participant’s average compensation over his or her highest three years of service for purposes of the Section 415 limit on benefits, the proposed regulations would have required “active participation.” The PPA eliminated this “active participation” requirement for years beginning after December 31, 2005, so that all of the periods of a participant’s service, including pre-participation years, may be taken into account in calculating a participant’s average compensation.

Multiple Annuity Starting Dates

The proposed regulations contained rules for determining the annual benefit for a defined benefit plan when there are multiple annuity starting dates. These rules have been removed from the final regulations and will be addressed in new proposed regulations. Until such guidance is issued, each annuity starting date must satisfy the Section 415 limit, taking into account the benefit that has or will be paid at all of the annuity starting dates.

Cost-of-Living Adjustments

The final regulations include two new safe harbors for situations where benefits are increased periodically by plan amendments that reflect cost-of-living adjustments. A plan may either incorporate by reference the cost-of-living adjustments, or adjust benefits in accordance with the two safe harbors which generally allow a plan to provide for increased benefits if those increases are not greater than the cost-of-living adjustment under Section 415. In addition, the final regulations provide that annual cost-of-living adjustments are not made 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) unless the plan specifies that the annual increase applies to such participants.

Partial QJSA Benefits

When a participant’s benefit is paid in the form of a qualified joint and survivor annuity (“QJSA”), the survivor annuity portion of the QJSA is not taken into account for purposes of the Section 415 annual benefit limit. The final regulations clarify that when benefits are partially in the form of a QJSA and partially in another form (e.g., a lump sum), the survivor annuity portion of the QJSA is still not taken into account.

Rules Affecting Defined Contribution Plans

Restorative Payments

The final regulations provide that restorative payments do not give rise to a defined contribution plan’s annual additions. The proposed regulations limited such restorative payments to those made to restore a plan for losses resulting from a fiduciary’s actions where there is a reasonable risk of liability for breach of fiduciary duty under Title I of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). The final regulations expand this provision to include restorative payments made to restore losses to a plan resulting from breaches of fiduciary duty with respect to plans that are not subject to ERISA. Therefore, payments to a defined contribution plan are restorative payments if such payments restore plan losses resulting from an action (or failure to act) which creates a reasonable risk of liability for breach of fiduciary duty under ERISA or other applicable federal or state law.

Correcting Excess Annual Additions

As under the proposed regulations, the final regulations do not include the correction methods for excess annual additions contained in the 1981 regulations. Pending further guidance, however, these correction methods are generally permitted and may be used under the Internal Revenue Service’s Employee Plans Compliance Resolution System regulations.

Other Rules in the Final Regulations

- **Actuarial Assumptions.** The final regulations simplify the calculation for converting another benefit form into an actuarially equivalent straight life annuity to determine whether a participant’s annual benefit exceeds the Section 415 limit. For forms of benefit which are not subject to the minimum present value rules of section 417(e)(3) of the Internal Revenue Code (*i.e.*, annuities), instead of converting another benefit form into a straight life annuity using the plan’s actuarial assumptions, the plan may use the straight life annuity that would be payable at the same age under the plan. The final

regulations also provide new actuarial assumptions to determine whether the amount payable under a straight life annuity exceeds the Section 415 limit applicable to defined benefit plans.

- **Adjustments for Early or Late Retirement.** The final regulations include simplified methods for adjusting the dollar limit for payments of benefits beginning before age 62 or after age 65. Generally, no adjustment is necessary to reflect the probability of a participant's death before age 62 or after 65 if a forfeiture does not occur upon a participant's death before the annuity starting date. The final regulations also provide that notwithstanding the generally applicable rules for age adjustments to the dollar limitation, the age-adjusted dollar limit does not decrease on account of an increase in age or the performance of additional service.
- **Aggregating Plans.** The final regulations limit the extent to which benefits under plans maintained by a predecessor employer must be aggregated. While all plans maintained by a predecessor employer are aggregated, the final regulations include a rule that prevents the double counting of a participant's benefit when applying the aggregation rule. Accordingly, the benefits which accrue after a transfer of benefits from the predecessor employer's plan to the employer's plan are excluded for purposes of applying the Section 415 limit with respect to the predecessor's plan. In addition, the final regulations retain the rule under the proposed regulations that 403(b) annuity contracts are generally not aggregated with 401(a) plans, unless the participant on whose behalf the 403(b) annuity contract is purchased is in control of any employer. If a 403(b) annuity contract is aggregated with a qualified plan of a controlled employer, the plans must satisfy the Section 415 limits both separately and on an aggregated basis. If a 403(b) annuity contract is aggregated with a qualified plan, the total compensation paid by both employers maybe taken into account in applying the Section 415 limit.

When applying the Section 415 limit to a 403(b) annuity contract and a qualified plan with which it must be aggregated, excess contributions must first be returned with respect to the 403(b) annuity contract and will be currently includible in income. Further, the issuer of the 403(b) annuity contract must maintain separate accounts for each portion attributable to such excess contributions.

- **Disqualification of Plans and Trusts.** The final regulations provide that a defined contribution

plan which is aggregated with an individual medical benefit account or a post-medical benefit account will be disqualified if the annual additions exceed the Section 415(c) limit.

- **Limitation Year.** The final regulations include a new rule for terminating a defined contribution plan: a defined contribution plan is deemed to have amended its limitation year if the plan terminates on a date other than the last day of the limitation year and, as a result, the annual dollar limit must be pro rated under the short limitation year rules.

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