

Pension ANALYST

Important Information

Plan Administration and Operation

August 2007



IRS Publishes Final Section 415 Rules for Defined Contribution Plans

WHO'S AFFECTED These rules affect sponsors of and participants in qualified defined contribution plans (including 401(k) plans and multiemployer plans) and 403(b) arrangements, including governmental plans and nonelecting church plans.

BACKGROUND AND SUMMARY Section 415 of the Internal Revenue Code limits the amount of contributions that may be made for a participant in a defined contribution plan. It also limits the amount of benefits that may be paid to a participant in a defined benefit plan. Comprehensive section 415 regulations were last issued in 1981.

Since 1981, a number of new laws have made changes to the section 415 rules. In response to those changes, the IRS published notices, revenue rulings, and other similar guidance, but had never revised the actual regulations until the April 5, 2007 publication of revised final regulations.

These final rules, which are generally effective for limitation years beginning on or after July 1, 2007, also contain some unexpected new provisions, which could significantly affect defined contribution plan administration. For example, the final rules:

- Clarify that amounts received following severance from employment are not compensation for 415 purposes, with a few exceptions,
- Provide that the annual additions dollar limit must be prorated if a plan is terminated on a day other than the last day of the limitation year, and
- Require plans to apply the 401(a)(17) compensation limit (\$225,000 for 2007) to section 415 compensation, but clarify that a plan does not need to determine compensation based on the earliest payments made during the year.

This *Pension Analyst* describes the major changes and clarifications of the final rules that affect defined contribution plans. A similar *Pension Analyst* discusses the final rules that affect defined benefit plans.

ACTION AND NEXT STEPS Plan sponsors should review the contents of this *Pension Analyst* to determine how the new rules affect plan provisions and plan administration. In some situations, plan amendments may be needed to bring plans into compliance with the new rules. If you have any questions about these new rules, please feel free to contact your Prudential Retirement representative.

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Annual additions made to a participant's account in a defined contribution plan during a limitation year cannot exceed the lesser of 100% of the participant's compensation ("the section 415 compensation limit") or \$40,000, as annually adjusted for cost-of-living increases ("the dollar limit").

In general, "annual additions" include employer contributions, employee contributions (except catch-up contributions), and forfeitures reallocated to participants' accounts. The annual limit must be applied to all annual additions made for a participant under all defined contribution plans (including non-ERISA 403(b) programs) sponsored by an employer.

In a significant change from previous guidance, the final section 415 rules provide that the annual additions dollar limit must be prorated if a plan is terminated on a day other than the last day of the limitation year, to reflect the shortened limitation year.

In addition, these final rules do not contain methods for correcting excess annual additions. Plans that are eligible for the [IRS Self-Correction Program](#) may use the correction methods that were provided in the previous section 415 rules. However, the excess annual additions (even if they relate to just one participant and are minimal in amount) must be treated as a "significant" operational failure and must be corrected by the end of the second plan year following the plan year in which they arose.

Annual Additions

The final section 415 rules contain important information clarifying the types of contributions that are counted as annual additions. The rules also address how the timing of certain contributions affects the application of the annual additions limit.

Restorative Payments

Consistent with previous IRS guidance, the final rules provide that restorative payments are not considered annual additions. In general, "restorative payments" are payments made to restore losses to a plan resulting from action that creates a reasonable risk of liability for breach of fiduciary duty under Title I of ERISA.

Recognizing that some plans (e.g., governmental plans and nonelecting church plans) are not subject to the ERISA fiduciary rules, these new rules expand the restorative payment definition to include breaches of fiduciary duty under *other applicable federal or state law*.

Contribution Timing

The final section 415 rules contain several new provisions regarding the timing of contributions and how that timing determines the year in which the contribution will be considered an annual addition:

- Contributions made by a tax-exempt employer (including a governmental entity) are included in annual additions if they are made no later than the 15th day of the tenth calendar month following the end of the calendar year or fiscal year containing the last day of the limitation year.
- While salary deferral contributions are generally considered to be employer contributions, the extended contribution deadlines do not apply if the [plan asset rules](#) impose an earlier contribution deadline.
- Contributions made to correct most nondiscrimination violations are treated as annual additions for the limitation year to which they relate. However, the final rules do not apply this rule to contributions made to correct ADP or ACP test failures. At this time, it is not clear if this was intentional or an oversight.

Determination of Compensation

The final section 415 rules continue to require plans to use one of four alternative definitions of compensation when determining a participant's section 415 compensation limit. These compensation definitions must also be used to identify highly compensated employees, identify key employees, calculate top-heavy plan minimum benefits, and compute a plan's deduction limit. However, the new rules make important changes to these four definitions, as described below.

Post-Severance Compensation

The new rules generally provide that amounts received after an employee's severance from employment are excluded from "section 415 compensation." However, certain types of payments are considered compensation if they are made by the later of:

- 2½ months after severance from employment; or
- The end of the limitation year (calendar year, for governmental plans) that includes the severance from employment date.

Post-severance regular pay (such as regular, overtime, shift differential pay, commissions, bonuses and other similar compensation) must be counted as section 415 compensation if it is paid within the above timeframe, and the payment would have been paid to the employee before his severance date if he had continued employment with the employer.

However, plans must specify whether the following types of post-severance payments are included in section 415 compensation:

- Payments of unused accrued bona fide sick leave, vacation, or other leave, but only if the employee would have been able to use the leave if employment had continued, and payment is made within the period specified above; and
- Payments received by an employee from a nonqualified unfunded deferred compensation plan, but only if the payment would have been paid to the employee at the same time if he had continued in employment with the employer and the payment is made within the period specified above.

- Compensation paid to employees who are performing [qualified military service](#), or employees who are permanently and totally disabled, regardless of when they are paid, as long as the payments do not exceed the amounts the employee would have received if employment had continued.

Other types of post-severance payments are excluded from section 415 compensation, even if they are made within the period described above. These include severance pay, parachute payments paid after severance, and deferred compensation payments that are triggered by severance.

The final rules also contain corresponding changes to clarify that amounts received by an employee following severance from employment may be contributed to a 401(k) plan or a section 457(b) plan as salary deferral contributions only if they are considered compensation under these final section 415 rules.

Special Types of Compensation

The final rules include important guidance regarding the following special types of compensation:

- Nonqualified deferred compensation plan amounts that are includible in income under either section 409A or 457(f)(1)(A) and amounts that are constructively received by an employee are treated as section 415 compensation.
- Foreign compensation paid to a non-resident alien employee is counted as section 415 compensation if it meets the definition of section 415 compensation, even though it is not includible in the employee's U.S. gross income. This important clarification allows non-resident aliens who do not have U.S.-source income to participate in plans that do not specifically exclude them.

Compensation Limit

In a major change from the prior rules, these final rules require plans to apply the section 401(a)(17) compensation limit (\$225,000 for 2007) to section 415 compensation when used to determine the section 415 compensation limit. The preamble to the regulations also states that a plan does not need to determine compensation based on the earliest payments made during the year. Although the regulation does not explain the meaning of the preamble, the clarification appears to be especially important for elective deferral contribution purposes. *For example, if Jane earns more than \$225,000 during the first half of 2008 but did not make any 401(k) contributions, the preamble implies that she may still make deferrals on up to \$225,000 of compensation received during the second half of the year. If Jane, however, had made deferrals in the first half of the year at a rate less than the plan permitted maximum, it is unclear without further IRS guidance whether section 415 would bar Jane from making deferrals up to the current section 402(g) limit (\$15,500 for 2007).*

Plan Aggregation Rules

For purposes of applying the annual additions limits, all defined contribution plans maintained by an employer are treated as a single defined contribution plan. For purposes of this aggregation requirement, the controlled group rules apply but a 50% controlling interest rule applies when identifying parent-subsidiary controlled groups, rather than the standard 80% rule (the final rules confirm that the standard 80% rule applies for brother-sister controlled group determinations). These final rules clarify that terminated plans, plans maintained by a predecessor employer, and plans that were formerly maintained by the employer or a related employer are also aggregated with the controlled group's active plans.

The Special Rules section, below, discusses the special aggregation rules that apply when an employee participates in a 403(b) arrangement.

Special Rules

403(b) Arrangements

The final section 415 rules include several special rules for 403(b) arrangements.

Determination of Compensation. The final rules continue to require 403(b) arrangements to use a participant's section 403(b)(3) "includible compensation" for purposes of applying the section 415 limits.

Plan Aggregation Rules. For purposes of the plan aggregation rules, the final rules generally treat a participant in a 403(b) arrangement (ERISA 403(b) plan or non-ERISA 403(b) program) as the employer maintaining the plan. As a result, contributions made to all 403(b) arrangements during a limitation year are subject to a single section 415 limit.

In addition, if a participant in a 403(b) arrangement has control over any employer that maintains a qualified defined contribution plan, a single section 415 limit applies to all annual additions made for him to the combined 403(b) arrangement and qualified plan. *For example, a doctor who is employed by a hospital makes salary deferral contributions to the hospital's 403(b) plan; he also owns more than 50% of a private practice that maintains a qualified defined contribution plan, in which he participates. A single section 415 limit would apply to all contributions made for the doctor to both plans.*

Correction of Excesses. Any excess annual additions must be set aside in separate accounts and included in the participant's income for the taxable year in which the limitation year ends. ERISA and non-ERISA arrangements could lose their 403(b) status if separate accounts are not maintained. If the section 415 limit is exceeded when 403(b) arrangements and qualified plans are aggregated, the excess annual additions are attributed to the 403(b) arrangement. The final regulations suggest that 403(b) plan sponsors must determine if participants are also covered by other defined contribution plans sponsored by an employer that the participant controls.

Multiple Employer Plans

Under the final rules, multiple employer plans are subject to some special rules regarding the application of the section 415 limits:

- All contributions from all employers maintaining the plan are subject to a single section 415 limit.
- When a multiple employer plan is aggregated with a single-employer plan maintained by the same employer for purposes of applying the section 415 limits, all of the contributions provided by the multiple employer plan must be counted, including contributions made by unrelated employers.
- When applying the section 415 compensation limit, the total compensation received by a participant from all employers maintaining the plan must be taken into account under the plan, unless the plan specifies otherwise.

Multiemployer Plans

The final rules include the following additional changes regarding the application of the annual additions limit to multiemployer plans:

- The section 415 limits may no longer be applied on an employer-by-employer basis. All annual additions from all employers maintaining the plan are subject to a single section 415 limit.

- A multiemployer plan can provide that if a participating employer maintains both a multiemployer plan and a single-employer plan, only the contributions provided under the multiemployer plan by that employer are aggregated with contributions provided under the single-employer plan for purposes of applying these limits.

Effective Dates and Plan Amendments

The final rules are effective April 5, 2007, but generally apply to limitation years beginning on or after July 1, 2007. *For a plan with a calendar limitation year, the final rules are effective January 1, 2008.*

For governmental plans, the regulations apply to limitation years that begin more than 90 days after the close of the first regular legislative session of the legislative body with authority to amend the plan that begins on or after July 1, 2007.

Sponsors of qualified plans must amend their plans to reflect these final rules.

- In general, a single-employer plan must be amended by the later of: (1) the due date (including extensions) for filing the employer's income tax return for the tax year that includes the effective date of the final rules; or (2) the last day of the plan year that includes the effective date of the final rules.
For example: Employer Y is a corporation with a calendar tax year and sponsors a 401(k) plan with a calendar plan year and a calendar limitation year. These final rules are effective January 1, 2008 for Employer Y's plan. Employer Y's tax filing due date for the 2008 tax year, which includes the effective date of these rules, is March 15, 2009. Employer Y receives an extension of this tax filing deadline to September 15, 2009. As a result, Employer Y must adopt a plan amendment reflecting the final section 415 rules by September 15, 2009.
- The amendment deadline for a single-employer governmental plan is the later of the deadline described above or the last day of the next legislative session held following the effective date of the regulations.
- The amendment deadline for a single-employer plan maintained by a tax-exempt employer (including a nonelecting church plan) is based on the deadline for filing the employer's Form 990.
- A multiple employer plan or multiemployer plan must be amended by the last day of the tenth month following the last day of the plan year that includes the effective date of these final rules.
- It is not entirely clear how the amendment requirements apply to 403(b) arrangements since the recently-published final 403(b) regulations, requiring written plans, are generally not effective until 2009.

In addition, plan amendments to include any of the optional provisions regarding post-severance compensation must be adopted by the end of the plan year in which the provision is effective.

Plan sponsors should review their plan documents to determine how the new rules affect plan provisions and plan administration. If Prudential Retirement provides document services for your plan, we will work with you to ensure that your plan complies with the various amendment deadlines. If you want to adopt one of the optional provisions regarding post-severance compensation, please contact your Prudential Retirement representative.

If you have any questions regarding the application of the final section 415 rules to your plan, please contact your Prudential Retirement representative.

Post-Severance Compensation Payments Chart

Type of Post-Severance Pay	Conditions to include in 415 Compensation	Required or Optional Inclusion in 415 Compensation
Regular Pay (regular, overtime, shift differential, commissions, bonuses, etc.)	Included in 415 compensation if made by the later of 2½ months following the severance of employment, or the end of the limitation year (calendar year for a governmental plan).	Required.
Payments for accrued bona fide sick leave, vacation, or other leave	May be included if made within the period described above, but only if the employee would have been able to use the leave if employment had continued.	Optional. If including these payments in compensation, the plan document must reflect the inclusion.
Payments from a nonqualified unfunded deferred compensation plan	May be included if made within the period described above, but only if the payment would have been made at the same time if employment had continued.	Optional. If including these payments in compensation, the plan document must reflect the inclusion.
Payments to individual while performing qualified military service	May be included as long as payments do not exceed amounts the individual would have received if he continued to work for the employer.	Optional. If including these payments in compensation, the plan document must reflect the inclusion.
Payments to an individual who is permanently and totally disabled	<p>May be included, as long as below conditions are satisfied:</p> <ul style="list-style-type: none"> • Either the participant is not a highly compensated employee immediately before becoming disabled, or the plan provides for the continuation of compensation on behalf of all participants who are permanently and totally disabled for a fixed and determinable period; • The plan provides that these amounts are compensation; and • Contributions made on this compensation are 100% vested. 	Optional. If including these payments in compensation, the plan document must reflect the inclusion.

Pension Analyst by Prudential Retirement

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