

# *Pension* ANALYST

Important Information

Plan Administration and Operation

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## IRS Issues Final Section 415 Rules for Defined Benefit Plans

**WHO'S AFFECTED** These rules affect sponsors of and participants in qualified defined benefit plans, including multiemployer plans, governmental plans and nonelecting church plans.

**BACKGROUND AND SUMMARY** Section 415 of the Internal Revenue Code limits the amount of benefits that may be paid to a participant in a defined benefit plan. It also limits the amount of contributions that may be made to a participant's account in a defined contribution 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 benefit plan administration. For example:

- For most plans, the section 415 limits will apply to both actual benefit payments made and annual benefit accruals.
- Only specific types of post-severance compensation may be included in section 415 compensation.
- The annual compensation amounts used in determining high-three average compensation will be subject to the \$200,000 compensation limit (\$225,000 for 2007).
- A single section 415 limit will apply to each participant in a multiemployer or multiple employer plan, even if a participant is employed by more than one contributing employer.

This *Pension Analyst* describes the major provisions of the final rules that affect defined benefit plans. A similar *Pension Analyst* discusses the final rules that affect defined contribution 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 the calculation of plan benefits. In some situations, plan amendments may be needed to bring plans into compliance with the new rules, and different amendment deadlines apply to various provisions. If you have any questions about these new rules, please feel free to contact your Prudential Retirement representative. Since some changes may affect plan funding, plan sponsors should also be sure to consult the plan's enrolled actuary before taking any amendment action.

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**Basic Limits**

The annual benefit payable to a participant in a defined benefit plan cannot exceed the lesser of \$160,000, as annually adjusted for cost-of-living increases (“the dollar limit”) or 100% of the participant’s “high-3 average compensation” (“the section 415 compensation limit”). The dollar limit must be adjusted if the participant has fewer than 10 years of participation in the plan or if benefit payments begin before age 62 or after age 65, subject to [certain exceptions](#).

The section 415 compensation limit does not apply to participants in:

- Governmental plans;
- Multiemployer plans; or
- Collectively-bargained plans.

The section 415 compensation limit also does not apply to participants in certain church plans who have never been highly compensated employees (HCEs). However, participants in all of these plans are still subject to the dollar limit.

In general, the final rules now require defined benefit plans to provide that neither the benefits actually paid to a participant nor a participant’s accrued benefit will exceed these limits. As a result, plans may no longer wait until a participant actually retires to test these limits. Instead, plans will need to test all active participants’ accrued benefits and then freeze future accruals for participants who reach the benefit limits. This requirement could put an additional strain on plans that provide suspension of benefits notices to postponed retirees, rather than allowing them to begin receiving benefit payments at normal retirement date. A plan sponsor that accidentally neglects to provide such a notice may not be able to correct the situation by providing an actuarial adjustment, if the participant’s accrued benefit has reached the section 415 limits.

It is unclear whether a [notice of benefit accrual reduction](#) (“204(h) notice”) will need to be provided to all participants or to just those participants affected by this accrued benefit limitation when it first applies under these new rules.

Since the law’s standard benefit accrual rules do not apply to governmental plans or nonelecting church plans, these plans are still only required to ensure that actual payments do not exceed the annual dollar limit.

## Annual Benefit

The “annual benefit” that is subject to these limits is a benefit payable as a straight life annuity. This benefit generally includes employer-funded retirement benefits only. As a result, the portion of a participant’s benefit that is paid for by mandatory employee contributions is not subject to these section 415 limits. The final rules clarify that benefits attributable to the following types of employee contributions also *are not subject to* these section 415 limits:

- Governmental plan 414(h) “pick-up” contributions;
- Repayments of plan loans made to a participant;
- Repayments of amounts that were previously distributed; and
- Rollover contributions received from any eligible retirement plans, not just those received from qualified plans.

Both required employee contributions (other than 414(h) pick-up contributions) and voluntary employee contributions made to defined benefit plans remain subject to the defined contribution annual additions limits.

In addition, the survivor portion of a Qualified Joint and Survivor Annuity (QJSA) is not subject to the annual benefit limit. The section 415 limits also do not apply to ancillary benefits such as disability benefits and Qualified Preretirement Survivor Annuities (QPSAs). However, the final rules clarify that any social security supplement provided under a plan is subject to these limits, even if the supplement is an ancillary benefit.

Unfortunately, these clarifications may make it more difficult to apply the annual limits since individual participants’ benefits may need to be disassembled and reassembled in different ways to reflect their actual contribution histories. In addition, as under the prior regulations, if a participant elects a form of payment other than a straight life annuity, the amount of benefit paid under that form of payment must be converted to the equivalent straight life annuity amount for purposes of applying the section 415 limits.

## Determination of High-3 Average Compensation

In general, a participant’s “high-3 average compensation” is his average compensation for the three consecutive calendar years during which he had the greatest total compensation from the employer. The new rules provide additional guidance for determining high-3 average compensation when a participant:

- Has been employed for fewer than three consecutive calendar years; or
- Terminated employment with the employer and was later rehired.

The final rules also provide important new guidance regarding the definition of compensation used in determining high-3 average compensation. They continue to offer four alternative definitions of compensation that may be used for purposes of applying the section 415 limits, as well as for top-heavy testing, identification of highly compensated employees, and certain types of nondiscrimination testing. However, they make three important changes to these definitions, as described below.

## Post-Severance Compensation

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

- 2 ½ months after severance from employment; or

- The end of the limitation year 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 in employment with the employer.

The determination of whether an employee is no longer an employee of the employer maintaining the plan is based on all relevant facts and circumstances. In the case of a multiemployer plan, an employee is treated as having a severance from employment only when the employee is no longer providing services to any employer maintaining the multiemployer plan.

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;
- 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 the employee had continued in employment with the employer and the payment is made within the period specified above; and
- Compensation paid to former employees who are in the U.S. military, 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 whose payment is triggered by severance.

### **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. Generally, benefits accrued or payable before the effective date of these final rules will not be affected by this new limitation. However, a participant cannot accrue additional benefits after the effective date if the additional accruals would violate the section 415 limits. To comply with the anti-cutback rules, plan sponsors may need to monitor future accruals and provide a notice of benefit accrual reduction (“204(h) notice”) if future accruals cease.

### **Nonresident Aliens**

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.

## **\$10,000 Exception**

A participant's benefit will automatically satisfy the section 415 limits, as long as it does not exceed \$10,000 and the participant has never participated in a defined contribution plan maintained by the employer. *For example, a participant who meets these requirements and whose section 415 compensation limit is \$6,000 may still receive an annual benefit of \$10,000.*

This \$10,000 limit is applied to actual payments made or benefits earned during each year. *For example, a single sum payment of \$14,000 does not satisfy the alternative limit, even if it is the actuarial equivalent of an accrued benefit with annual payments that would total less than \$10,000.*

## **Plan Aggregation Rules**

For purposes of applying the section 415 limits, all defined benefit plans maintained by an employer are aggregated and treated as a single defined benefit 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 standard 80% rule applies for brother-sister controlled group determinations). The 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.

In particular, the final regulations include the following special rules regarding terminated plans:

- If a plan terminates in a standard termination, all other defined benefit plans maintained by the sponsoring employer's controlled group must take into account all of the benefits accrued under the terminated plan when applying the section 415 limits.
- However, if a plan terminates in a distress or involuntary termination, the other defined benefit plans maintained by the sponsoring employer's controlled group must only take into account the benefits that are actually provided by the Pension Benefit Guaranty Corporation (PBGC) to participants under the terminated plan.

## **Special Rules**

### **Governmental Plans**

The Pension Protection Act of 2006 (PPA) extended the exception from the early retirement reduction requirement for qualifying police and fire department employees in governmental plans to apply to police and fire employees who are participants in a plan maintained by an Indian tribal government. The final rules clarify that this exception is not based on the participant's job classification but only applies if the employer is a police department or fire department of the state, Indian tribal government or political subdivision.

### **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 benefits 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 benefits provided by the multiple employer plan must be counted, including benefits provided 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 section 415 limits to multiemployer plans:

- The section 415 limits may no longer be applied on an employer-by-employer basis. All benefits from all employers maintaining the plan are subject to a single section 415 limit. As noted earlier, only the dollar limit applies to benefits accrued and payable from multiemployer plans.
- A multiemployer plan can provide that if a participating employer maintains both a multiemployer plan and a single-employer plan, only the benefits provided under the multiemployer plan by that employer are aggregated with benefits under the single-employer plan for purposes of applying the dollar limit. The compensation limit would only apply to benefits accrued and payable from the single-employer plan.

If Prudential Retirement provides actuarial valuation services to a multiemployer plan, we are prepared to apply the aggregation rules, but only if we provide services to the corresponding single-employer plan. If we do not provide services to the corresponding single-employer plan, the plan sponsor would need to provide the annual accrued benefit for each participant covered by the multiemployer plan and the single-employer plan in order to administer the aggregation rules.

## 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.

The IRS intends to publish sample plan language to reflect the final rules. However, they do not intend to publish a model amendment for adoption by plan sponsors.

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 X is a corporation with a calendar tax year and sponsors a defined benefit plan with a calendar plan year and a calendar limitation year. These final rules are effective January 1, 2008, for Employer X's plan. Employer X's tax filing due date for the 2008 tax year, which includes the effective date of these rules, is March 15, 2009. Employer X receives an extension of this tax filing deadline to September 15, 2009. As a result,*

*Employer X 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.

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.

In addition, there are special timing rules in the case of certain plan amendments required as the result of changes made to section 415 by PFEA and PPA. For example, PPA extended the PFEA due date to incorporate [certain interest rate assumptions for lump sum payments](#) to December 31, 2008. In addition, a plan amendment that is made to incorporate the provisions of PPA must be made on or before the last day of the first plan year beginning on or after January 1, 2009 (January 1, 2011, in the case of a governmental plan).

Plan sponsors should review their plan documents to determine how the new rules affect plan provisions and benefit calculations. 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 Prudential Retirement provides actuarial valuation services, we will apply the new rules regarding the limitations on benefit accruals as of the appropriate effective date for your plan. In addition, if we provide benefit calculation services, we will apply the new section 415 rules to benefit payments made on and after the appropriate effective date for your plan.

Plan sponsors will need to advise us of any benefits that may be due, or have been paid to a participant who has accrued benefits under other employer-sponsored defined benefit plans. This may include payments attributable to:

- Prior periods of employment;
- Employment with another division or employer within a controlled group; or
- A terminated plan.

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

#### **Pension Analyst by Prudential Retirement**

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