

Final Code Section 415 Regulations: Defined Contribution Plans *By Anne C. Hydorn*

On April 4, 2007, the Treasury Department released final regulations under Code section 415. Code section 415 generally requires that limits be placed on benefits paid under defined benefit plans and contributions and other additions made to defined contribution plans. These comprehensive new regulations apply to limitation years that begin on or after July 1, 2007. Thus, for calendar year plans, the rules become effective January 1, 2008. This article examines the new regulatory guidance under Code section 415(c) affecting defined contribution plans. Please see our website at www.hansonbridgett.com/newsletters/EmployeeBenefitsUpdate for our articles discussing defined benefit plans and governmental retirement plans.

A. Section 415 Definition of Defined Contribution Plans

As under the proposed regulations, the final regulations describe what types of arrangements are considered a “defined contribution plan” for purposes of section 415. The general rule under section 415 is that a defined contribution plan is a plan providing participants with individual accounts in which the participants’ benefits are based solely on the amount contributed to the accounts, plus allocable income, losses, expenses and forfeitures. This includes a qualified plan, an annuity plan under section 403(a), or a simplified employee pension plan and generally all contributions to such plans are measured against the 415(c) limits. Other contributions also treated as contributions to a defined contribution plan under section 415(c) include:

- mandatory contributions to a defined benefit plan (other than governmental plan “pick-up” contributions);

- annual additions to section 403(b) annuity contracts;
- contributions allocated to individual medical accounts under Code section 401(h); and
- contributions to post-retirement medical accounts for key employees under Code section 419A(d)(1).

B. Annual Limitations

1. Statutory Annual Limit

The final regulations reflect the statutory limitations that apply to defined contribution plans. For any limitation year, the annual additions must not exceed the lesser of (a) \$45,000 (as adjusted based on inflationary considerations) (2007 amount), or (b) 100% of the participant’s compensation (as defined under the regulations and also discussed further below).

2. Annual Additions

Annual additions generally include employer contributions, employee contributions, and forfeitures allocated to a participant’s account under a defined contribution plan. Under the final regulations, annual additions do not include the following:

- direct transfers of benefits or employee contributions from another qualified plan to a defined contribution plan;
- reinvestments of employee stock ownership plan dividends;
- certain restorations of accrued benefits by the employer (discussed below);

- age-50 catch-up contributions;
- distributed excess deferrals;
- rollover contributions;
- loan repayments;
- repayments of previously distributed benefits;
- repayments of certain contributions to governmental plans; and
- contributions to qualified cost of living arrangements within the meaning of section 415(k)(2).

The final regulations clarify that restorative payments do not give rise to an annual addition. A restorative payment is a payment to a plan to restore losses resulting from fiduciary actions that have a reasonable risk of liability under Title I of the Employee Retirement Income Security Act (ERISA). At the suggestion of commentators, the Treasury Department expanded this definition in the final regulations to also include situations in which the risk of a breach of fiduciary liability arises under other applicable federal or state law to take into account plans that are not subject to ERISA.

The regulations specifically delineate the types of payments that will qualify as a restorative payment: (a) payments made pursuant to a Department of Labor order; (b) payments made pursuant to the Department of Labor's Voluntary Fiduciary Correction Program; and (c) payments made pursuant to a court-approved settlement.

3. Timing Rule for Annual Addition Allocations

The general rule is that annual additions are credited to a participant's account if allocated under the plan terms as of any date in the limitation year. The final regulations clarify that, if under the plan terms, the allocation is dependent on the satisfaction of a condition (for example, continued employment), the annual addition is considered allocated as of the date the condition is satisfied.

The final regulations retain the rule that an employer contribution is not treated as credited to a participant's account for a limitation year unless it is actually made to the plan no later

than 30 days after the due date, including extensions, of the employer's tax return for the taxable year in which the limitation year ends. For tax-exempt employers, however, the final regulations mirror the proposed regulations which state that contributions must be made to the plan not later than the 15th day of the tenth calendar month following the end of the calendar year or fiscal year (depending on which the employer uses for accounting purposes) in which the limitation year ends.

C. Compensation

The amount of annual additions to a participant's account in a defined contribution plan cannot exceed the lesser of \$45,000 (as adjusted based on inflationary considerations) or 100% of the participant's "compensation" as defined under Code section 415(c)(3). The amount that may be allocated to that individual within an employer's defined contribution plan is directly impacted by the 415 definition of compensation. This definition of compensation is also used for many other purposes under the Code and the Treasury Department enumerates these various uses in the Preamble to the final regulations. The definition of 415 compensation is, therefore, a key component in a variety of circumstances with respect to retirement plans.

1. Statutory Changes

The final regulations reflect various statutory changes made to Code section 415(c)(3) since 1981 regarding amounts included in compensation. Namely, nontaxable elective amounts deferred under plans sections 401(k), 403(b), and 457, Code section 125 (cafeteria plans), and 132(f) (qualified transportation benefits) are now included in the 415(c)(3) definition of compensation under the final regulations.

2. Post-Severance Payments

The final regulations retain the limit from the proposed regulations regarding the inclusion of certain post-severance payments, but expanded the timing under which such payments could be made. The final regulations include post-severance payments in 415(c)(3) compensation if the payments are paid within the later of 2-1/2 months following severance from employment or the end of the limitation year that includes the date of severance. Governmental plans can substitute "calendar year" for "limitation year" in the above timing determination. Post-severance payments

that can be included are:

- payments that are regular compensation for services during the employee's regular working hours or compensation for services outside regular working hours (such as overtime, shift differential, commissions, bonuses, or other similar payments), and that would have been paid to the employee prior to severance if the employee had continued employment.
- payments for unused accrued bona fide sick, vacation or other leave, but only if the employee would have been able to use such leave if the employee had continued employment;
- payments received by an employee pursuant to 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 only to the extent that the payment is includible in the employee's gross income.

The final regulations require that plans specifically include past-severance bona fide leave payments and nonqualified deferred compensation plans payments in compensation for purposes of the 415 limitations.

D. Other Rules and Clarifications

The final regulations also provide certain other new rules and clarifications regarding section 415 of which plan sponsors

should be aware:

- The final regulations clarify that amounts includible in an employee's gross income as a result of the rules under section 409A or section 457(f)(1)(A) are includible in compensation.
- Amounts that are constructively received by an employee are also includible in compensation.
- The final regulations clarify that amounts are not excluded from compensation merely because they are not included in gross income on account of where the services are performed (i.e., foreign compensation). Thus, nonresident aliens are not precluded from participating in a qualified retirement plan solely on account of 415 limitations.
- Back pay awarded by an administrative agency, a court, or pursuant to a bona fide agreement by an employer is includible in compensation in the limitation year to which the back pay relates.
- Defined contribution plans that terminate on a date other than the last day of the plan year are deemed to have changed their limitation year such that the short limitation year rules apply.

In light of the final regulations, plan sponsors are advised to review their plans and operations soon to ensure compliance and readiness for the first plan year in which the rules go into effect.

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