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## **Pension Protection Act of 2006: IRS Issues Final Regulations on Annual Benefit Limitations For Tax- Qualified Plans**



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The Internal Revenue Service (“IRS”) has issued final regulations under Internal Revenue Code (“Code”) Section 415, the section of the Code that limits the annual benefits for defined benefit plans and the “annual additions” for defined contribution plans (including 403(b) plans and SEPs) and defines “compensation” for such purposes. The regulations bring together various statutory changes and guidance issued by the IRS since 1981 including provisions addressing changes brought about by the Pension Protection Act of 2006 (“PPA”).

The statutory changes reflected in the final regulations are listed below. A discussion of some of the key changes and the effective date follows. The changes reflected in the final regulations include the following:

- current statutory limits applicable for defined benefit and defined contribution plans, as most recently amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”);
- changes to the rules for age adjustments to the applicable limits under defined benefit plans, under which the dollar limit is adjusted for commencement before age 62 or after age 65;
- changes to the rules for benefit adjustments under defined benefit plans;
- phase-in of the defined benefit plan dollar limit over 10 years of participation under Code Section 415(b)(1)(A);
- addition of the limit on compensation that is permitted to be taken into account in determining plan benefits under Code Section 401(a)(17), and the interaction of this requirement with the other benefit and contribution limits;
- exceptions to the compensation-based limit under Code Section 415(b)(1)(B) for governmental plans and multiemployer plans;
- changes to the aggregation rules under which multiemployer plans are not aggregated with single-employer plans for purposes of applying the compensation-based limit of Code Section 415(b)(1)(B) to a single-employer plan;
- repeal of the limit on the combination of a defined benefit plan and a defined contribution plan;
- changes made in conjunction with EGTRRA’s repeal of the exclusion allowance under Code Sec. 403(b)(2);
- current rounding and base period rules for annual cost-of-living adjustments under Code Sec. 415(d), most recently amended in EGTRRA and the Working Families Tax Relief Act of 2004;
- changes under which certain types of arrangements are no longer subject to the defined contribution plan limit (e.g., individual retirement accounts other than SEPs), and other types of arrangements have become subject to those limits (e.g., certain individual medical accounts);
- inclusion in compensation (for limit purposes) of certain salary reduction amounts not included in gross income;

- modification for distributions with annuity starting dates in plan years beginning in 2004 and 2005 made by the Pension Funding Equity Act of 2004 with respect to the interest rate assumptions in Code Sec. 415(b)(2)(E) for converting certain forms of benefits to an actuarially equivalent straight life annuity; and
- the following modifications to Code Sec. 415 that were made by the PPA:
  - changes to the interest rate assumptions in Code Sec. 415(b)(2)(E) that are used for converting certain forms of benefits to an equivalent straight life annuity;
  - elimination of the active participation requirement in determining a participant's high-3 years of service in Code Sec. 415(b)(3);
  - exemption from the Code Sec. 415(b)(1)(B) compensation limit for certain benefits provided under a defined benefit plan maintained by certain churches; and
  - expansion of the definition of a “qualified participant” under Code Sec. 415(b)(2)(H) to include certain participants in a defined benefit plan maintained by an Indian tribal government.

### **Limits on Benefits and Contributions**

The defined benefit limit for 2007 is the lesser of \$180,000 or 100 percent of the average of the participant’s high three-year compensation. For defined contribution plans, in 2007, the limit is the lesser of \$45,000 or 100 percent of the participant's compensation; the limit on “annual additions” applies to all employer contributions, employee contributions and forfeitures. As a related matter, for 2007, the maximum amount of a participant's compensation that may be taken into account for retirement plan benefits or contributions is \$225,000.

With these limitations in effect, the IRS has clarified that the overall compensation limit of \$225,000 must be taken into account to determine compensation under a defined benefit plan for the purposes of high three-year compensation. As a related matter, following the PPA, the years calculated in the high three-year compensation can be based on service prior to the effective date of the plan.

The final regulations add helpful clarification for so-called “restorative payments” to a defined contribution plan. These are contributions made due to a reasonable risk of liability for breach of fiduciary duties. Under the final regulations, restorative payments do not affect the limit on annual additions. In other words, if an employer makes a restorative contribution in a plan limitation year, it will not affect the amount that may otherwise be contributed during such plan year.

### **The Definition of Compensation**

One of the more problematic issues under the compensation regulations is the treatment of payments made after a severance from employment. The proposed regulations generally limited the inclusion of post-severance pay to payments in the 2½-month period after severance. The final regulations expand the applicable period to the later of 2½ months after severance or the end of the limitation year that includes the date of severance. However, it is important to note that the final regulations retain the narrow limitations on what can be considered post-severance pay included for such purposes. Generally, only payments of regular pay, cashouts of accrued leave time, and payments of deferred compensation that would have been paid to the employee prior to a severance of employment had the employee continued employment will be included in compensation for purposes of Code Section 415(c)(3). However, the final regulations also provide that post-severance payments of accrued bona fide sick, vacation, and other leave paid within the period noted above are not included in compensation *unless* the plan specifically includes such payments. This is a matter that will need to be addressed in plan amendments addressing the new regulations. As a related matter, the regulations also include an exception to the timing rule for compensation paid to certain disabled participants. For employers with 401(k) and 403(b) plans, the changes in the compensation definition are important because the regulations provide that elective deferrals can only be made from compensation as defined in Code Section 415(c)(3).

### **Aggregation Rules**

Section 415 contains rules requiring the aggregation of all defined benefit or defined contribution plans in

the same controlled group. The final regulations include clarification regarding the treatment of employment by a predecessor employer. Among other things, the regulations limit the extent to which a plan maintained by an employer must aggregate benefits accrued under a plan that was formerly maintained by the employer or that was maintained by an entity that was formerly affiliated with the employer.

### **Other Rules**

As noted above, the regulations include a number of provisions addressing changes in the PPA. In addition, the regulations provide guidance on determining a plan's limitation period where plans have different limitation years. They also update the definition of compensation as it relates to the top-heavy rules by providing an alternative definition.

### **Effective Date**

The regulations are generally effective for plan limitation years beginning on or after July 1, 2007. For calendar year plans, this will mean that the regulations are effective as of January 1, 2008; however, for fiscal year plans (July 1 to June 30), the regulations will be effective in less than three months on July 1, 2007. Although compliance is required when the regulations take effect, plan amendments generally will not be required until the end of the plan's remedial amendment period. For example, for 2008, calendar-year plans will not need to be amended for the final regulations until the due date for filing the 2008 tax return (with extensions). However, for changes made with respect to the PPA, the amendment generally would not be required until the end of 2009 for most calendar-year plans.

If you have any questions about the new regulations, please contact one of the attorneys on the Boulton Cummings [Employee Benefits and Executive Compensation](#) Team listed below:

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