RE: **Final 415 Regulations Related to Governmental Defined Benefit Plans**
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The following memorandum summarizes key provisions of the final 415 regulations that apply to governmental defined benefit plans but is not intended as a comprehensive review. The authors are not attorneys and the statements made are not legal advice or opinion. Qualified legal counsel should be consulted as plans review and amend their provisions in light of the new regulations.

EXECUTIVE SUMMARY

On April 4, 2007, the IRS issued final regulations relating to benefit and contribution limits for qualified retirement plans under Internal Revenue Code (Code) § 415.[1] The final regulations consolidate statutory changes and IRS guidance issued since the regulations were last updated in 1981.[2] They clarify and, in some cases, substantially modify the prior regulations. The final regulations generally become effective for plan limitation years beginning on or after July 1, 2007; however, extended effective dates are provided for governmental plans as described at the end of this memorandum.

Because the § 415 regulations are complex, this memorandum begins with an executive summary, providing an overview of the basic rules. The remainder of the memorandum describes the regulations in more detail, providing background for more technical discussions with the plan's legal counsel and actuary about implementing the changes.

Generally, Code § 415 limits the benefits provided by defined benefit (DB) plans and the amounts contributed to defined contribution (DC) plans. The § 415 limits are qualification requirements under Code § 401(a), and a plan that does not adhere to the limits risks disqualification by the IRS.[3] In determining the limits, all DB plans of the same employer (whether or not terminated) are aggregated as one DB plan for testing purposes. Similarly, all DC plans of the same employer are aggregated as one DC plan.[4]

For DB plans, Code § 415(b) limits the employer-provided portion of a benefit provided to a participant in a given year. The limit is the lesser of a specific dollar amount ($180,000 in 2007, indexed to inflation[5]) or 100% of the participant's average compensation for the highest three consecutive years. Although private-sector plans are subject to both limits, governmental DB plans are exempt from the limit related to average compensation for the highest three consecutive years.[6]

The employer-provided portion is the benefit attributable to employer contributions, and does not include the portion attributable to employee contributions. For testing purposes, the benefit is expressed as the actuarial equivalent of a "straight-life annuity" (i.e., an annuity payable in equal

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[1] The 415 Final Regulations were published on April 5, 2007, in Vol. 72, No. 65 of the *Federal Register*, pages 16878 – 16931. (72 FR 16878 – 16931)

[2] However, the final regulations do not address qualified governmental excess benefit arrangements under Code § 415(m) or purchases of service credit in governmental plans under Code § 415(n).

[3] Code § 415(a)(1).

[4] Code § 415(f).

[5] The § 415(b) dollar limit is indexed to the Consumer Price Index (CPI) in increments of $5,000.

[6] Code § 415(b)(11).

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amounts over the participant's lifetime). Moreover, the dollar limit is actuarially reduced for retirement commencing before age 62 (and possibly increased for retirement commencing after age 65), as discussed later in this memorandum. Much of the complexity inherent in the § 415 regulations relates to the rules for making these actuarial adjustments.

For DC plans, Code § 415(c) limits the "annual additions" that can be made each year to a participant's DC account to the lesser of a specific dollar amount ($45,000 in 2007, indexed to inflation[7]), or 100% of the participant's annual compensation. Governmental DC plans are subject to both of the DC limits.[8] Annual additions include employer contributions, employee contributions, and forfeitures, but not rollovers from qualified plans. For the purpose of testing annual additions under § 415(c), a participant's compensation includes elective deferrals to §§ 401(k), 403(b), 457(b), 125 "cafeteria" plans, and certain transportation fringe benefits under § 132(f)(4).[9]

In addition to limiting DB plan benefits and DC plan contributions, the Code also limits compensation that can be used for benefit purposes. Code § 401(a)(17) limits the annual compensation that may be taken into account when calculating contributions to or benefits provided from a qualified plan ($225,000 in 2007, indexed to inflation[10]). For all private-sector plan participants and for public-sector plan participants hired after 1995, only compensation up to the § 401(a)(17) dollar limit may be taken into account by the plan. However, special rules apply to certain state and local plan participants hired before 1996.[11]

As noted above, the final regulations consolidate statutory changes made to the § 415 rules, clarifying some rules and substantially changing others. As described in the remainder of this memorandum, plan administrators should carefully consider the clarifications and changes made in the following areas:

- Adjusting the dollar limit for benefits commencing before age 62 and after age 65;
- Incorporating mortality in adjustments to the dollar limit;
- Adjusting the form of benefit, particularly for benefits paid as lump sum distributions, partial lump sum distributions, and for periods certain;
- Adjusting the benefit for rollovers and transfers; and,
- Adjusting the benefit for automatic cost-of-living adjustments.

While the final regulations continue to allow plans to incorporate the § 415 regulations by reference, doing so without further elaboration could mean some of the new safe harbor rules would not apply. Consequently, it would be useful for governmental plans to consider providing additional language in plan documents to take advantage of the new provisions. The remainder of this memorandum describes the final 415 regulations in greater detail.

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[7] The § 415(c) dollar limit is indexed to the CPI in increments of $1,000.
[8] The § 415(c) limits apply to DC plans established under Code § 401(a). Different limits apply to DC-type plans established under Code §§ 401(k), 403(b), and 457.
[9] Code § 415(c)(3)(D).
[10] The § 401(a)(17) limit is indexed to inflation in increments of $5,000.
[11] Treas. Reg. § 1.401(a)(17)-1(d)(4). The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) lowered the § 401(a)(17) maximum compensation limit from $200,000 to $150,000, indexed to inflation. Under the transition rules, governmental plans were allowed to grandfather compensation limits specified in the plan as of July 1, 1993, for employees hired before 1996 – provided the plan was amended to apply the OBRA '93 limits to employees hired in 1996 and after. For governmental plans applying the pre-OBRA '93 limits, the maximum compensation limit in 2007 is $335,000 for grandfathered employees. For governmental plans that had no maximum compensation limit as of July 1, 1993, and that amended the plan to grandfather these provisions, benefits can be determined without reference to any compensation limit for grandfathered employees.

THE 415(b) DB LIMITS FOR STATE AND LOCAL GOVERNMENTAL PLANS

The 415 limits apply annually over the "limitation year." By default, the limitation year is the calendar year. However, an employer may elect any other consecutive 12-month period as the limitation year by adopting a written resolution amending the plan.[12]

> **Comment:** It is important for governmental plans to consistently use the correct limitation year in accordance with plan documents. It is also important to inform the actuary of the limitation year and of any changes to the limitation year.

Generally under Code § 415(b), the unreduced DB plan dollar limit ($180,000 in 2007) applies to the employer-provided portion of the benefit, expressed as a straight-life annuity commencing between the ages of 62 and 65. The dollar limit is actuarially reduced for benefits commencing before age 62. (Note: This pre-age 62 reduction in the dollar limit is not required for certain qualified participants, as discussed on page 5 of this memorandum.) In addition, the dollar limit may be actuarially increased for benefits commencing after age 65, provided the increase is included in the plan provisions.

As defined in the final regulations, a straight-life annuity is an annuity payable in equal installments for the life of a participant ending upon the participant's death.[13] For benefits provided in forms other than a straight-life annuity (e.g., lump sum distributions, period certain annuities) and for benefits that are attributable to after-tax mandatory employee contributions, the value of the benefit is adjusted to the actuarial equivalent of a straight-life annuity for testing under § 415(b).

ADJUSTING THE DOLLAR LIMIT FOR BENEFITS COMMENCING BEFORE AGE 62 OR AFTER AGE 65

General Rule. Code § 415(b)(2)(C) generally requires that the dollar limit be actuarially reduced for benefits commencing before age 62, using prescribed interest rates and mortality tables. For benefits commencing after age 65, the dollar limit is actuarially increased using a similar methodology, but only if this increase is specifically provided by the plan.

Calculating the Dollar Limit for a Benefit Commencing Before Age 62. For a benefit with an annuity starting date that begins before age 62, the 415(b) dollar limit is reduced to the actuarial equivalent of an annual straight-life annuity beginning at the annuity starting date and having the same present value as a deferred straight-life annuity equal to the unreduced 415(b) dollar limit beginning at age 62. The actuarially equivalent straight-life annuity is calculated using "statutory factors" - a 5% interest rate and the applicable § 417(e) mortality table that is effective for that annuity starting date.[14] The participant's age is based on computed calendar year months as of the annuity starting date.[15]

However, if the plan provides for an immediately commencing straight-life annuity at the annuity starting date and also at age 62, a second age-adjusted dollar limit is calculated equal to the unreduced dollar limit multiplied by the ratio of the straight-life annuity commencing at the annuity starting date and the straight-life annuity commencing at age 62. The age-adjusted dollar limit used

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[12] Final Treas. Reg. § 1.415(j)-1.
[13] Final Treas. Reg. § 1.415(b)-1(B)(1)(i).
[14] For limitation years beginning before January 1, 2008, the applicable 417(e) mortality table under Treas. Reg. § 1.417(e)-1(d)(2) is the 1994 Group Annuity Reserving Table (94 GAR) 50/50, projected to 2002. For limitation years beginning on or after January 1, 2008, the applicable mortality table will be based on the mortality table required for minimum funding purposes, as determined by the IRS before the end of 2007.
[15] Final Treas. Reg. § 1.415(b)-1(d)(1)(i).

for testing purposes is the **lesser** of the age-adjusted limit calculated using the statutory factors and the age-adjusted limit calculated using the plan annuities.[16]

> **Example**: Plan A provides early retirement benefits that are reduced by 4% for each year that the early retirement age is less than age 65. Participant M retires from Plan A at age 60 with a straight-life annuity of $100,000 payable at age 65, but which Participant M can elect to take at age 60 (reduced to $80,000) or age 62 (reduced to $88,000). Assuming the unreduced 415(b) dollar limit is $180,000, the age-adjusted dollar limit for testing Participant M's benefit at age 60 would be $163,636 using the plan annuities (i.e., $180,000 x $80,000/$88,000) and $156,229 using the statutory factors.[17] The dollar limit used to test Participant M's benefit would be $156,229, the lesser of the two.

Calculating the Dollar Limit for a Benefit Commencing After Age 65. For a benefit with an annuity starting date after age 65, the age adjusted dollar limit is determined in much the same way as a benefit commencing before age 62. The age-adjusted limit is increased to the actuarial equivalent of an annual straight-life annuity beginning at the annuity starting date that has the same actuarial present value as a straight-life annuity beginning at age 65, where the annuity payments under the straight-life annuity beginning at age 65 are equal to the unreduced dollar limit for that year. Actuarial equivalence is calculated using the statutory factors - a 5% interest rate and the applicable mortality table under § 1.417(e)-1(d)(2) that is effective for that annuity starting date.

If the plan provides for immediately commencing straight-life annuities at both the annuity starting date and at age 65, a second age-adjusted dollar limit is calculated as the unreduced dollar limit multiplied by the ratio of the straight-life annuity at the annuity starting date (disregarding benefit accruals after age 65 but including actuarial adjustments) and the straight-life annuity at age 65. For testing purposes, the age-adjusted dollar limit is the **lesser** of the age-adjusted limit calculated using the statutory factors and the age-adjusted limit calculated using plan annuities.[18]

> **Comment:** The final regulations indicate that it is inappropriate to increase the dollar limit for benefits commencing after age 65 where, under the terms of the plan, there is no increase in a participant's benefit on account of the delayed commencement.[19] For many governmental plans, members who work past age 65 simply continue to earn credit for years of service and salary increases – there is no actuarial adjustment for delayed commencement.

Mortality Adjustments. To the extent that the benefit is not forfeited upon a participant's death, the dollar limit is not adjusted to reflect the probability of the participant's death between the annuity starting date and attainment of age 62 (or after age 65). In other words, the probability of mortality may be ignored in adjusting the dollar limit if the benefit is not forfeited upon the participant's death. Ignoring mortality results in a higher dollar limit than would otherwise be the case prior to age 62.

- The final regulations permit a plan to treat the benefit as not being forfeited if the plan "does not charge participants" for providing a qualified preretirement survivor annuity

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[16] Final Treas. Reg. § 1.415(b)-1(d)(1)(i), (ii).

[17] Final Treas. Reg. § 1.415(b)-1(d)(7). In the examples provided with the final regulations, $156,229 is the value of a straight-life annuity at age 60 that is actuarially equivalent to a deferred annuity of $180,000 at age 62, determined using 5% interest and the applicable mortality table. The example assumes the plan provides a qualified preretirement survivor annuity (QPSA) at no charge to the participant. Therefore, the dollar limit adjustment does not include a mortality decrement for the period between 60 and 62, as discussed in the section on mortality adjustments.

[18] Final Treas. Reg. § 1.415(b)-1(e)(1)(i).

[19] Final Treas. Reg. Preamble, Part E. (72 FR 16883)

(QPSA),[20] but only if the plan applies this treatment to adjustments both before age 62 and after age 65.[21]

Exception for Qualified Participants. No age reduction in the dollar limit is made for a participant in a governmental DB plan with at least 15 years of service in the plan as: (1) a full-time employee of a governmental police or fire department providing police protection, firefighting services, or emergency medical services, or (2) as a member of the U.S. Armed Forces.[22] Consequently, the dollar limit for these participants is the same as the unreduced dollar limit regardless of retirement age.

- The final regulations clarify that the application of this rule to public safety employees depends on whether the employer is a police or fire department of a state, political subdivision, or Indian tribal government, rather than the job classification of the individual participant. The final regulations also clarify that the rule applies based on the organization's function rather than the organization's name.[23]

Comment: This clarification was sought by many governmental employers and plans.

Exception for Survivor and Disability Benefits. No age reduction in the dollar limit is made for a distribution from a governmental plan on account of the participant's becoming disabled by reason of personal injuries or sickness, or as a result of the participant's death.[24]

ADJUSTING THE FORM OF BENEFIT

General Rule. Under Code § 415(b)(2)(B), if a DB plan pays a benefit in a form other than an employer-provided straight-life annuity, the benefit is actuarially adjusted to a value equivalent to a straight-life annuity beginning at the same age for testing under 415(b). Benefits requiring adjustment include those paid as a full or partial lump sum distribution, a non-qualified joint and survivor annuity, for a period certain, or for which employees make mandatory contributions, rollover contributions, or transfers.

Benefits Not Taken Into Account. Certain forms of benefits are not included in the value of the benefit tested under § 415(b). For example, the additional value of a qualified joint and survivor annuity (QJSA) is not taken into account.[25] In addition, other "ancillary benefits" that are not directly related to retirement benefits are also not taken into account, including: pre-retirement disability benefits (that do not exceed the retirement benefit payable at normal retirement age), pre-retirement incidental death benefits (including a qualified preretirement survivor annuity), and post-retirement medical benefits.[26]

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[20] Generally, a qualified preretirement survivor annuity (QPSA) is a life annuity for the surviving spouse of a participant who dies before the annuity starting date, and is actuarially equivalent to the payment that would have been made to the surviving spouse under a qualified joint and survivor annuity.
[21] Final Treas. Reg. § 1.415(b)-1(d)(2) & 1.415(b)-1(e)(3).
[22] Final Treas. Reg. § 1.415(b)-1(d)(3).
[23] Final Treas. Reg. Preamble, Part F. (72 FR 16884)
[24] Final Treas. Reg. § 1.415(b)-1(d)(4).
[25] Generally, a qualified joint and survivor annuity (QJSA) is an annuity for the life of the participant with a survivor annuity for the life of the participant's spouse. The amount of the annuity may not be less than 50% nor no more than 100% of the annuity payable during the period the participant and spouse are both alive, and at least actuarially equivalent to an annuity for the life of the participant only.
[26] Final Treas. Reg. § 1.415(b)-1(c)(4)(i)(B). A preretirement disability benefit that exceeds the service retirement benefit payable at normal retirement age would be subject to the adjustment for form of benefit and tested under the § 415(b) dollar limit. However, no age reduction in the dollar limit would be made if the distribution were paid from a governmental plan on account of the participant's becoming disabled by reason of personal injuries or sickness, or as a result of the participant's death.

- The final regulations clarify that if benefits are paid partly in the form of a QJSA and partly in another form (e.g., a lump sum distribution), the portion paid as the survivor benefit is not taken into account in determining the annual benefit.[27] This applies to the QJSA exception to the portion of the benefit paid in the form of a QJSA, but not to the portion paid in another form (e.g., as a lump sum).

  Comment: Some plans have joint and survivor options where the reduced joint and survivor annuity increases ("pops-up") to the value of a single-life annuity upon the death of the spouse. It appears that the value of such pop-ups should be taken into account in determining the annual benefit for testing purposes.

- The final regulations also clarify that Social Security supplements are included in determining the annual benefit. Although the supplements might otherwise be considered ancillary benefits, the IRS considers them directly related to retirement income.[28]

Adjusting a Form of Benefit Not Subject to § 417(e)(3). For straight-life annuities, qualified joint and survivor annuities, and other forms of benefits **not** subject to § 417(e)(3), the final regulations simplify the process for adjusting the form of benefit. Under the simplified rules, the value of the equivalent straight-life annuity for testing purposes is the **greater** of:

- The annual amount of the straight-life annuity (if any) payable to the participant under the plan, commencing at the same annuity starting date as the form of benefit payable to the participant; and,

- The annual amount of the straight-life annuity commencing at the same annuity starting date that has the same actuarial present value as the form of benefit payable to the participant, computed using a 5% interest assumption and the applicable 417(e) mortality table for the annuity starting date.[29]

Adjusting a Form of Benefit Subject to § 417(e)(3). For governmental plans, the final regulations significantly change the process used to adjust forms of benefit subject to § 417(e)(3), including: full and partial lump sum distributions, period certain only distributions, and possibly DROPs and BackDROPs, among others.[30]

> **Comment:** Prior to the final regulations, governmental plans did not distinguish between benefits subject and not subject to § 417(e)(3) because they were not required to make this distinction.[31] However, the final regulations specifically state that forms of benefit subject to § 417(e)(3) are to be adjusted as such, regardless of whether § 417(e)(3) applies to the plan (including governmental plans).[32]

[27] Final Treas. Reg. § 1.415(b)-1(c)(4)(ii)(B).
[28] Final Treas. Reg. § 1.415(b)-1(c)(4)(ii)(A).
[29] Final Treas. Reg. § 1.415(b)-1(c)(2).
[30] While § 417(e)(3) is generally understood to apply to lump sum distributions, it also applies to other forms of benefit, such as 10-year certain only annuities. More importantly, § 417(e)(3) applies to plans with partial lump sum options, whether based on a multiple of the monthly benefit or on the contribution balance. Further, for § 415(b) testing purposes, it is possible that § 417(e)(3) may apply to many DROPs and BackDROPs. Also some level income options may be subject to § 417(e)(3) if they do not qualify as Social Security options.
[31] Revenue Ruling 98-1, Q&A 3, explicitly states governmental plans are not subject to the § 417(e)(3) interest rate requirement of Code § 415(b)(2)(E)(ii). Q&A 7 of the same ruling directed governmental plans to use the 5% interest rate for this purpose.
[32] Final Treas. Reg. Preamble, Part A. (72 FR 16882)

For benefits paid in a form to which § 417(e)(3) applies, the actuarial straight-life annuity for testing under 415(b) is determined as the **greatest** annual straight-life annuity commencing at the annuity starting date that has the same actuarial present value as the particular form of benefit payable, computed using:

- The interest rate and mortality table (or tabular factor) specified by the plan for actuarial equivalence;
- A 5.5% interest assumption and the applicable 417(e) mortality table for the distribution; and
- The applicable 417(e) interest rate and the applicable 417(e) mortality table for the distribution, with the result divided by 1.05.[33]

Applicable § 417(e) Interest Rate. For plan years beginning before January 1, 2008, the applicable interest rate under Treas. Reg. § 1.417(e)-1(d)(3) is the annual rate on 30-year Treasury securities for the month before the distribution. For plan years beginning on or after January 1, 2008, the interest rate structure will be the "adjusted first, second, and third segment rates" for the month before the distribution. These segment rates are based on the corporate bond yield curve, grouped by maturities of less than 5 years (first segment), between 5 and 15 years (second segment), and greater than 15 years (third segment) as published by the U.S. Treasury. The change in the rates will be phased in over a 5 year period ending 2012.

> **Comment:** By the effective date of the final regulations, governmental plans will need to include these changes in adjusting the form of benefit for testing under § 415(b). In the interim, they may continue to rely on Revenue Ruling 98-1, which allows governmental plans to adjust all forms of benefit as if they were not subject to § 417(e)(3).

Adjusting a Form of Benefit for Timing of Benefit Payments. The final regulations also provide that if the benefit is payable in the form of a straight-life annuity, no adjustment is made to account for differences in the timing of payments during a year (e.g., no adjustment is made on account of the annuity being payable in annual or monthly installments). For example, if the dollar limit for a given year is $180,000, a plan is not permitted to provide for 12 monthly installments of $15,583 (i.e., the actuarial equivalent of $180,000 payable at the beginning of the year).[34]

With respect to a benefit payable in a form other than a straight-life annuity, the annual benefit is determined as an actuarially equivalent straight-life annuity payable on the first day of each month.[35]

<u>Adjusting the Benefit for Mandatory (After-Tax) Employee Contributions</u>

Under Code § 415(b)(2)(A), benefits attributable to mandatory employee contributions are excluded from the employer-provided benefit before testing against the 415(b) limits. Mandatory employee contributions are defined as those required to be contributed by the employee as (1) a condition of employment, (2) a condition of participation in the plan, or (3) as a condition of obtaining benefits (or additional benefits) under the plan.[36] These contributions also include payments for service purchases made on an after-tax basis.

- The final regulations clarify that if voluntary (non-mandatory) employee contributions are made to the plan, the portion of the plan to which the voluntary contributions are made is treated as a DC plan pursuant to Code § 414(k). Accordingly, the portion of a plan to which

[33] Final Treas. Reg. § 1.415(b)-1(c)(3).
[34] Final Treas. Reg. Preamble, Part A. (72 FR 16882)
[35] Final Treas. Reg. Preamble, Part A. (72 FR 16882)
[36] Final Treas. Reg. Preamble, Part H. (72 FR 16884)

voluntary contributions are made is not a DB plan and is not taken into account in determining the annual benefit under the DB portion of the plan.[37]

Picked-Up Contributions Included in the Employer-Provided Benefit. For governmental plans that "pick-up" employee contributions under Code § 414(h)(2), such pre-tax picked-up contributions are included in the employer-provided benefit subject to the § 415(b) dollar limits.[38] This includes picked-up contributions to purchase service credit.

- The final regulations also clarify that certain other employee contributions are to be included in the employer-provided benefit, such as: (1) repayments of any loans made from the plan and (2) repayments of any previously distributed or withdrawn contributions.[39] However, with regard to previously distributed or withdrawn contributions, the employee's original contributions would still be excluded from the employer-provided portion of the benefit.[40]

Calculating the Benefit Attributable to Employee Contributions. Under the final regulations, the value of the annual benefit attributable to mandatory employee contributions is determined under the rules of Code §§ 411(c)(2)(B) and (C), regardless of whether § 411 applies to the plan (including governmental plans).[41] The calculation is made through a two-step process. First, interest is accumulated on the contributions using the applicable interest rates specified in § 411(c) as follows:

Contribution Date	Applicable Interest Rate
Before 1976	the rate (if any) in the plan document
1976 - 1987	5%[42]
1988 – DD*	120% of the mid-term applicable federal rate
DD thru NRD**	the applicable § 417(e) interest rate (see page 7)
* DD is the "determination date" - generally, the date the benefit commences or the annuity starting date. ** NRD is the "normal retirement date" - generally, the date at which unreduced benefits are paid.[43]	

Second, the accumulated value of the contributions with interest is converted to an annuity value using the applicable 417(e) interest rate and the applicable 417(e) mortality table. The annuity value of the mandatory after-tax contributions is then subtracted from the total benefit to obtain the employer-provided portion of the benefit tested under § 415(b).

- The final regulations also provide that for purposes of determining accumulated contributions under § 411(c)(2)(C), where the plan is not subject to § 411, the plan must

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[37] Final Treas. Reg. § 1.415(b)-1(b)(2)(iv).
[38] Final Treas. Reg. § 1.415(b)-1(b)(2)(ii)(A).
[39] Final Treas. Reg. § 1.415(b)-1(b)(2)(ii)(B)&(C).
[40] Final Treas. Reg. Preamble, Part H. (72 FR 16885)
[41] Final Treas. Reg. § 1.415(b)-1(b)(2)(iii). Arguably, the provisions of §§ 411 and 417 should not be applied to governmental plans under § 415. Code § 411(e) states that the vesting standards of Code § 411 do not apply to governmental plans. In addition, as acknowledged in Revenue Ruling 98-1, governmental plans are exempt from the requirements of Code § 417(e)(3). However, Treasury/IRS argue that any amount payable with respect to employee contributions in excess of the amount determined using § 411(c) and § 417(e) is effectively an employer subsidy that should be included in determining the benefit tested under § 415, regardless of whether §§ 411 and 417 apply to the plan.
[42] The Code § 411(c)(2)(C)(iii) rate before amendment by the Omnibus Budget Reconciliation Act of 1987, 12/22/87.
[43] Many governmental plans allow unreduced retirement benefits to be paid after a certain number of years of service (e.g., 25 or 30); therefore, they do not have a specific age for "normal retirement benefits." Consequently, the "normal retirement date" for these plans might best be defined as the date on which unreduced benefits begin. In situations where reduced benefits are paid prior to attaining the age and service required for unreduced benefits, the determination date (DD) would reasonably be the starting date of the reduced benefits and the normal retirement date (NRD) would be the earliest date at which the unreduced benefits would otherwise have been paid.

determine what would have been the applicable effective date of § 411(a)(2) (which is used to determine the beginning date from which interest is credited to the mandatory contributions) as if § 411 applied to the plan. In determining the annual benefit that is actuarially equivalent to the accumulated contributions, the plan must determine the interest rate that would have been required under § 417(e)(3) as if § 417 applied.[44]

Comment: The vesting rules of Code § 411(a)(2) were added by the Employee Retirement Income Security Act of 1974 (ERISA) and generally apply to plan years beginning after Sept. 1, 1976, unless the plan was in existence on January 1, 1974, in which case they generally apply to plan years beginning after 1975.[45]

Adjusting the Benefit for Rollovers

Generally, if a DB plan provides a defined benefit from a rollover, the benefit attributable to the rollover is excluded from the benefit tested against the § 415(b) limits.[46] This would occur, for example, if a distribution from a DC plan or an IRA is rolled into a DB plan to purchase service credit.

- Under the final regulations, the annual benefit attributable to the rollover is determined in the same manner as the annual benefit attributable to mandatory employee contributions.[47] As a result, if the plan uses more favorable factors to determine the value of the annuity resulting from the rollover, the benefit tested under § 415(b) would include the additional value of the annuity benefit above the amount that would have been payable using the interest rate and mortality assumptions under § 411(c). The IRS considers this additional amount to constitute an employer subsidy that should be included in the benefit tested under § 415(b).[48]

The final regulations also clarify that rollovers to a separate individual account under § 414(k) do not give rise to an additional DB benefit, since the separate account is treated as a DC plan. Moreover, rollover contributions to a DC plan are excluded from the definition of annual additions.[49]

Adjusting the Benefit for Transfers

The final regulations modify current rules for determining the value of transferred benefits that are excluded from the annual benefit tested under the § 415 limits. Under the final regulations, treatment of the transferred amounts depends on whether or not the transfer is made between plans that are required to be aggregated for § 415(b) testing purposes under Code § 415(f). Plans that must be aggregated for testing purposes include all DB plans of the same employer (whether or not terminated). Plans that are not aggregated for testing purposes include DB plans maintained by different employers.

- **Transfers between aggregated plans –** For plans that are aggregated under Code § 415(f), to the extent the transferred amounts must be aggregated, the transferred benefits are included in determining the annual benefit under the plan receiving the transfer ("transferee plan") and are disregarded in determining the annual benefit under the plan

[44] Final Treas. Reg. § 1.415(b)-1(b)(2)(iii).
[45] Treas. Reg. § 1.411(a)-2(a) and (b).
[46] Final Treas. Reg. § 1.415(b)-1(b)(2)(v).
[47] Final Treas. Reg. § 1.415(b)-1(b)(2)(v).
[48] Final Treas. Reg. Preamble, Part I. (72 FR 16885)
[49] Final Treas. Reg. § 1.415(c)-1(b)(3)(i).

making the transfer ("transferor plan").[50] Consequently, the annual benefits tested under § 415(b) are the actual benefits provided under each plan after the transfer.

- **Transfers between plans that are not aggregated –** For plans that are not aggregated under § 415(f), the final regulations are more complicated. For the plan making the transfer, the transferred benefits are treated as if they were annuities from a terminating plan (with sufficient assets to pay benefit liabilities) that must be aggregated with the plan making the transfer. Although the transfer is treated as a plan termination in computing the annual benefit under the plan making the transfer, no corresponding adjustment is made to the annual benefit under the plan receiving the transfer. The actual benefit provided by the plan receiving the transfer is used to determine the annual benefit tested under the 415(b) limit.[51]

- **Elective transfers of a distributable benefit** – Where a distributable benefit is voluntarily transferred from either a DB plan or a DC plan, the amount transferred is treated as a benefit paid from the plan making the transfer and the annual benefit provided by the plan receiving the transfer does not include the amount attributable to the transferred benefit (determined under the rollover rules). In the case of a governmental DC plan (or other DC plan not subject to § 411), this rule applies even if the participant's benefits from the DC plan were not distributable at the time of the transfer.[52]

  Comment: This is an important provision for certain governmental plans that have statutory transfer provisions from deferred compensation plans to defined benefit plans in various circumstances (e.g., service purchase transfers, covered position changes, etc.).

Adjusting the Form of Benefit for Automatic COLAs

The final regulations significantly modify the 2005 proposed regulations for plans with automatic cost-of-living adjustments (COLAs). Under the proposed regulations, plans would have been required to include the value of an automatic COLA in the form of benefit tested under § 415(b), potentially reducing benefits payable to amounts below the dollar limit. Under the final regulations, plans will not need to include the automatic COLA in the benefit tested, provided the following conditions are met:

- **The plan must specifically limit the actual benefit paid in any year to no more than the § 415 dollar limit for that year, adjusted for commencement age and form of payment** (i.e., death benefits other than under a QJSA).[53]

- **The form of benefit may not be subject to IRC § 417(e)(3).**[54] As discussed above, this includes full and partial lump sum distributions, period certain only annuities, and possibly DROPs and BackDROPs. Also some level income options may be subject to § 417(e)(3) if they do not qualify as Social Security options. This opens up the possibility that some options under a plan will be subject to the rules in the proposed regulations on COLAs, while other forms would be subject to these more intuitive rules.

The regulations make clear that plans covered by these new rules include plans with an automatic increase based on a fixed percentage, with an increase tied to an index (e.g., the CPI), or with an increase based on a share of favorable investment returns on plan assets.[55]

[50] Final Treas. Reg. § 1.415(b)-1(b)(3)(i)(A). Also Preamble, Part J. (72 FR 16885)
[51] Final Treas. Reg. Preamble, Part J. (72 FR 16885)
[52] Final Treas. Reg. § 1.415(b)-1(b)(3)(ii).
[53] Final Treas. Reg. § 1.415(b)-1(c)(5)(iii).
[54] Final Treas. Reg. § 1.415(b)-1(c)(5)(i)(A).
[55] Final Treas. Reg. § 1.415(b)-1(c)(5)(ii).

Comment: To get the maximum benefit from this provision, the plan must explicitly permit the recognition of the § 415(d) increase in the dollar limit on the limitation amount after retirement. This is an example where incorporating the § 415 limits by reference would not be enough to secure this advantage, as discussed on page 14 of this memorandum.

ADJUSTING THE DOLLAR LIMIT FOR INFLATION

Code § 415(d) requires the IRS to periodically adjust the § 415(b) dollar limit for inflation, based on changes in the Consumer Price Index (CPI), rounded to the next lowest multiple of $5,000. A similar adjustment is made to the DC dollar limit, rounded to the next lowest multiple of $1,000. In conjunction with this adjustment, a plan may increase benefits otherwise limited by 415(b), but only if the plan explicitly permits such increases and does so in conformance with the regulations.

The adjusted dollar limit applicable to DB plans is effective as of January 1 of each calendar year and applies with respect to limitation years ending with or within that calendar year. However, benefit payments cannot exceed the currently applicable dollar limit prior to January 1. Thus, when there is an increase in the limit, any associated increase in a participant's benefit associated with the increase in the limit is permitted to occur no earlier than January 1 of the calendar year for which the limit increase is effective, and can only be applied to payments due on or after January 1 of that calendar year.[56]

Example: A participant receives a straight-life annuity, payable monthly, from a DB plan with a July to June limitation year. If the plan is amended to reflect the 415(d) increase that is effective January 1, 2009, the associated increase in the participant's monthly benefit is only effective for payments due on or after January 1, 2009 (and not for payments prior to that date).

Applying the 415(d) Adjusted Dollar Limit to Benefits that Have Commenced. Under the final regulations, the adjusted dollar limit is permitted to be applied to participants who have previously begun to receive benefits under the DB plan, as well as to former employees who have retired or otherwise terminated service with a nonforfeitable right to benefits. For participants who have begun receiving benefits, the adjusted dollar limit is only applicable to the extent benefits have not been paid. For example, a plan cannot apply the adjusted dollar limit to a participant who previously received the entire benefit as a lump sum distribution.[57]

A plan can apply the adjusted dollar limit to a retired participant who accrues additional benefits under the plan (e.g., through a plan amendment or COLA) that would otherwise have been limited by the 415 dollar limit.[58] To do so, the plan must apply one of two "safe harbor" rules:

- **First Safe Harbor.** A plan amendment would satisfy the first safe harbor if the amounts payable to an employee on or after the effective date of the adjustment are not greater than the amounts otherwise payable without the adjustment, multiplied by the ratio of the § 415(d) adjusted dollar limit (applicable to the age at benefit commencement) to the immediately prior dollar limit (similarly applicable) – but not to exceed the amount that would otherwise be payable under the plan.[59]

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[56] Final Treas. Reg. § 1.415(d)-1(a)(3).
[57] Final Treas. Reg. § 1.415(d)-1(a)(4)(iii).
[58] Final Treas. Reg. § 1.415(d)-1(a)(4)(iii).
[59] Final Treas. Reg. § 1.415(d)-1(a)(5).

- **Second Safe Harbor.** A plan amendment would satisfy the second safe harbor if the amounts payable to an employee on or after the effective date of the adjustment are not greater than the amounts otherwise payable, adjusted for the "cumulative adjustment fraction." This fraction is equal to the product of all fractions that would have been applied after benefit commencement if the plan had been amended each year to incorporate the § 415(d) adjustments to the § 415(b) limits.[60]

  Comment: This second safe harbor may help relieve ad hoc COLAs from subjection to the multiple annuity starting date rules.

MULTIPLE ANNUITY STARTING DATES

The 2005 proposed regulations presented an entirely new and extremely complicated set of 415 calculations for annuities with "multiple annuity starting dates."[61] Under the 2005 proposed regulations, the rules would apply in situations where a participant received one or more distributions in limitation years prior to a benefit increase during the current limitation year. Among other situations, this might occur as a result of:

- Post-retirement benefit increases due to an additional benefit accrual obtained as a result of a return to service;
- Post-retirement COLAs pursuant to an adjustment in the 415(b) dollar limit; or
- Qualified domestic relations orders (or similar orders) where the alternate payee's benefit commences before the member's. When the member retires, it appears the combined benefit would be tested under the rules for multiple annuity starting dates.

The final regulations postpone implementation of the multiple annuity starting date rules, stating that revisions to the proposed regulations are needed before the rules are adopted in final form.

In the interim, the final regulations provide that if a participant has or will have distributions commencing at more than one annuity starting date, the limitations of § 415 must be satisfied as of each of the starting dates, taking into account the benefits that have or will be provided at all annuity starting dates. In determining the annual benefits of a participant as of a particular starting date, the plan is required to actuarially adjust past and future distributions with respect to the benefit that commenced at the other annuity starting dates.[62]

CHANGES TO DEFINED CONTRIBUTION LIMITS UNDER 415(C)

As mentioned at the beginning of this memorandum, Code § 415(c) limits the annual additions made to a DC plan participant's account to the lesser of a specific dollar amount ($45,000 in 2007, indexed to inflation), or 100% of the participant's annual compensation. Annual additions include employer contributions, employee contributions, and forfeitures, but not rollovers from qualified plans. For the purpose of testing annual additions under § 415(c), a participant's compensation includes elective deferrals to §§ 401(k), 403(b), 457(b), 125 "cafeteria" plans, and certain transportation fringe benefits under § 132(f)(4).[63]

- The final regulations modify the definition of compensation under § 415(c)(3) to include compensation paid after separation from service to the extent it is paid by the later of 2½ months after separation or the end of the limitation year within which the separation

[60] Final Treas. Reg. § 415(d)-1(a)(6).
[61] Proposed Treas. Reg. § 1.415(b)-2.
[62] Final Treas. Reg. § 1.415(b)-1(b)(1)(iii).
[63] Code § 415(c)(3)(D).

occurs. To qualify, the compensation would have to have been paid to the participant if he or she had continued employment or be paid as bona fide sick, vacation, or other leave.[64]

- The final regulations also incorporate statutory changes to the types of arrangements subject to the § 415(c) limits. For example, contributions allocated to individual medical accounts that are part of a pension or annuity plan under Code § 401(h) are treated as contributions to a DC plan under § 415, and are subject to the dollar limit under Code § 415(c)[65]

Comment: Governmental plans with leave conversion programs need to carefully review the timing in the compensation definition described above. Moreover, governmental plans with individual accounts in their 401(h) structure will need to recognize the change that requires the § 415(c) dollar limit to be applied, as well as aggregated with other defined contribution plans sponsored by the employer.

EFFECTIVE DATES AND GRANDFATHER PROVISIONS

The § 415 final regulations are effective April 5, 2007, and generally apply to limitation years beginning on or after July 1, 2007.[66] However, for governmental plans, the final 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."[67] Governmental plans are permitted to apply the provisions to limitation years beginning on or after July 1, 2007.

Comment: For plans of governments whose legislatures meet on an annual calendar year basis, the final rules would apply to the limitation year that begins 90 days after the close of the legislative session beginning January 1, 2008. If the legislature meets for more than 3 months during 2008, and the plan has a July to June limitation year, the final regulations would not be effective before July 1, 2009.

Grandfather Provisions – General. Under the final regulations, a defined benefit plan is deemed to satisfy the § 415(b) limitations with respect to "benefits accrued or payable under the plan as of the end of the limitation year that is immediately prior to the effective date of final regulations under this section."[68] However, such plan provisions must meet the statutory provisions, regulations, and other published guidance relating to § 415 in effect before April 5, 2007.

Comment: The reference to the "effective date of final regulations" is ambiguous. It could mean April 5, 2007, (technically the effective date of the final regulations) or the effective date of the regulations for the plan (e.g., as extended for governmental plans). The preamble to the regulations states: "Under these regulations, a defined benefit plan is considered to satisfy the limitations of section 415(b) for a participant with respect to benefits accrued or payable under the plan as of the end of the limitation year that is immediately prior to the effective date of these final regulations for the plan pursuant to plan provisions … that were adopted and in effect before April 5, 2007…"[69] Consequently, it seems reasonable to conclude that the "effective date of final regulations" refers to the effective date of the final regulations for the plan.

[64] Final Treas. Reg. § 1.415(c)-2(e)(3).
[65] Final Treas. Reg. § 1.415(c)-1(a)(2)(ii)(C); Code § 415(e)(1).
[66] Final Treas. Reg. § 1.415(a)-1(g)(1).
[67] Final Treas. Reg. § 1.415(a)-1(g)(2).
[68] Final Treas. Reg. § 1.415(a)-1(g)(4).
[69] Final Treas. Reg. Preamble, Effective Dates. (72 FR 16893)

Grandfather Provisions – PFEA and PPA Rules. Also under the grandfather rules, plan provisions will not be treated as failing to satisfy the requirements of the statutory provisions, regulations, and other published guidance in effect immediately before the effective date of the final regulations merely because the plan has not been amended to reflect the changes to § 415(b) made by the Pension Funding Equity Act of 2004 (PFEA) and the Pension Protection Act of 2006 (PPA).[70]

Under the PFEA prior to amendment by the PPA, a plan was required to use the 5.5% interest rate assumption for determining the actuarial equivalence of a straight-life annuity for a form of benefit subject to § 417(e)(3) for distributions with annuity starting dates in 2004 and 2005. Moreover, a plan amendment to reflect this change was required on or before the last day of the first plan year beginning on or after January 1, 2006. However, as amended by PPA § 301(c), a plan is treated as having been operated in accordance with PFEA § 101(c) if the plan is operated in conformity with the amendment and the amendment is adopted no later than Dec. 31, 2008.[71]

> **Comment:** The final regulations specifically require use of the 5.5% rate for determining the actuarial equivalence of a form of benefit subject to § 417(e)(3), regardless of whether 417 applies to the plan. However, it does not appear that prior distributions for such benefits would need to be recalculated. Prior to issuance of the 415 final regulations, it was understood that the 5.5% interest rate under IRC § 415(b)(2)(E)(ii) did not apply to governmental plans, as provided under Revenue Ruling 98-1, Q&A 3.

INCORPORATING THE FINAL 415 REGULATIONS IN THE PLAN

Defined benefit plans are allowed to incorporate the 415 rules and regulations "by reference." This is done by stating in the plan documents that benefits are limited by Code § 415 and related regulations, without including the specific 415 rules. The final regulations continue to allow incorporation by reference, but warn that doing so without further elaboration would mean the "default" rules of § 415 would apply. Consequently, if a provision of § 415 is intended to be implemented to take advantage of a safe harbor or other "non-default" provision (e.g., for treatment of automatic cost-of-living adjustments), the plan documents must describe the specific manner in which the provision applies.[72]

> **Comment:** Thus, many governmental plans will need additional language in their plan documents to reflect their decisions related to non-default 415 testing provisions.

QUALIFIED EXCESS BENEFIT ARRANGEMENTS

While defined benefit plans risk disqualification if they do not adhere to the § 415(b) limit, the Code provides a mechanism through which governmental plans may pay benefits in excess of the limit. Under Code § 415(m), state and local governments may establish a "qualified excess benefit arrangement" and use it to pay the portion of the benefit in excess of the § 415(b) limit, effective January 1, 1995. Thus the § 415(b) limit does not apply to benefits provided under a qualified excess benefit arrangement.[73] However, under Code § 415(m)(3)(C), the funds used to pay benefits over the § 415 limit must be held separately from the pension trust.

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[70] Final Treas. Reg. § 1.415(a)-1(g)(4).
[71] Final Treas. Reg. Preamble, Effective Dates. (72 FR 16893)
[72] Final Treas. Reg. § 1.415(a)-1(d)(3)(ii).
[73] Final Treas. Reg. § 1.415(b)-1(b)(4).

CONCLUSION

Overall, the final regulations present a complicated framework for testing benefits provided by DB plans and annual additions made to DC plans. It is important for plan administrators to review current plan provisions with qualified legal counsel in light of the final regulations and amend the plans accordingly in a timely manner.

Circular 230 Notice: Pursuant to regulations issued by the IRS, to the extent this communication (or any attachment) concerns tax matters, it is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) marketing or recommending to another party any tax-related matter addressed within. Each taxpayer should seek advice based on the individual's circumstances from an independent tax advisor.