Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues

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Keeping Abreast of Plan Limitations

Qualified retirement plans are funded by contributions from employers and/or employees. These contributions are subject to a number of annual limitations. In defined benefit plans, some of the limits are based on the maximum benefit that can be provided at retirement. Adherence to these limitations is important since the qualification of the plan is at stake.

Recently released regulations to Internal Revenue Code (IRC) section 415 have made changes that impact plan limits effective for plan years beginning after June 30, 2007. Let's take a close-up look at plan limitations and the manner in which they are calculated.

Compensation

Contribution and benefit limits are based in part upon participants' compensation. The maximum compensation that can be considered for plan purposes for plan years beginning in 2007 is $225,000. Generally, compensation for limitation purposes must include all forms of remuneration paid to an employee. Salary deferrals to qualified plans under any of the following IRC sections must also be included: 401(k), 403(b), 457, 125 (cafeteria plans) and 132(f)(4) (transportation fringe benefit plans). Compensation also includes deemed payments to disabled participants.

Under the new regulations, compensation paid after an employee's termination date ("post-severance compensation") will not be included unless (1) it is paid within 2½ months of employment termination or by the end of the limitation year, if later, and (2) it would have been paid had the employee remained employed.

For partners and self-employed owners of unincorporated businesses, compensation means net earnings with certain adjustments. Net earnings are reduced by 50% of self-employment tax as well as employer contributions to retirement plans made on behalf of the partner or self-employed individual. Salary deferrals are not deducted from net earnings for limitation purposes.

In S corporations, only income that is distributed to the owner as wages, subject to social security taxes, can be used for retirement plan purposes. Pass-through income is not included.

Limitation Year

The measuring period for contribution and benefit limitations is called the "limitation year" and is usually the plan year. However, a different 12-month period may be elected by the employer. Where a change in the limitation year results in a short plan year of less than 12 months, the annual additions, annual benefit and compensation limits are pro-rated accordingly. Under the new regulations, this now applies to plans that terminate prior to the last day of the limitation year.

Annual Additions Limit

IRC section 415(c) provides the maximum "annual additions" that can be allocated to an individual's account in a defined contribution plan (profit sharing, 401(k), etc.). Annual additions include:

- Employer contributions;
- Employee contributions (deductible or after-tax); and
- Forfeitures allocated to the participant's account.

The annual additions limit is the lesser of:

- 100% of a participant's compensation, or
- A specified dollar amount–for limitation years ending in 2007, the dollar limit is $45,000.

Defined Benefit Limit

Contributions to a defined benefit plan are actuarially calculated to fund the retirement benefits provided under the plan. Under IRC section 415(b), the annual benefit limit at normal retirement ages between 62 and 65 is the lesser of:

- 100% of a participant's high consecutive three-year average compensation, or
- A specified dollar amount–for limitation years ending in 2007, the dollar limit is $180,000.

The limit is actuarially adjusted for retirement ages above 65 and below 62.

Plan Aggregation

For limitation purposes, all defined contribution plans of an employer are treated as one plan, and all defined benefit plans of an employer are treated as one plan.

Plans sponsored by related employers must also be aggregated for limitation purposes, including the compensation from such related employers. A related employer can be a controlled group of businesses (parent-subsidiary or brother-sister groups) or an affiliated service group. Controlled groups are connected by stock ownership rules, while affiliated service groups are connected through business operations, including the management of the businesses and/or the services provided.

A section 403(b) plan will not be combined with other plans of the same employer because a 403(b) plan is considered to be maintained by each individual employee for section 415 purposes. However, if a 403(b) plan participant owns more than 50% of a business, then that business is considered to be the sponsor of the owner's 403(b) plan for section 415 purposes. As a result, any other plan sponsored by such business must be combined with the owner's 403(b) plan for limitation purposes.

Under the new regulations, plans of a predecessor employer and plans of a formerly related employer must also be aggregated for section 415 purposes.

Salary Deferrals

Employees are allowed to make salary deferrals to section 401(k), 403(b) and 457 plans. The annual deferral limit into these plans is the lesser of:

- 100% of compensation, or
- $15,500 for the 2007 calendar year ($10,500 for SIMPLE plans).

Note that the deferral limit is not based on the plan year but on the calendar year. Where an employee participates in two or more salary deferral plans of different employers in a calendar year, it is the employee's responsibility to make sure he does not exceed the annual limit. If so, he must take steps to initiate the necessary refunds by April 15th of the following year.

Participants who are considered "highly compensated employees" (generally 5% owners and those earning over $100,000) may be subject to an additional deferral limit based on the plan's average deferral percentage (ADP) test.

Catch-Up Contributions

Individuals age 50 and over as of the last day of the calendar year may be eligible to make additional deferrals into their salary reduction plans, if permitted under the terms of the plan. These "catch-up" contributions are limited to $5,000 for 2007 ($2,500 for SIMPLE plans). Catch-up contributions are defined as deferrals in excess of any one of the following:

- The annual dollar deferral limit ($15,500 for 2007);
- The annual additions limit ($45,000 for 2007);
- The ADP test limit; or
- Any plan imposed deferral limit.

Catch-up contributions are not counted when determining if other limitations have been met but actually serve to extend these limitations. Consequently, in salary deferral plans, the annual additions limit is extended from $45,000 to $50,000 and the deferral limit is extended from $15,500 to $20,500 for participants age 50 and over.

Contribution Deductions

One advantage of a qualified plan is that the employer contributions to the plan are tax deductible. Separate deduction limits apply to defined benefit plans, defined contribution plans and a combination of the two. Contributions that are not deductible are subject to a 10% excise tax.

The Pension Protection Act of 2006 (PPA) made a number of changes to the contribution deduction rules.

Defined Contribution Plans

For defined contribution plans, the deduction limit is 25% of the total plan compensation of all eligible participants. Salary deferrals are not counted towards the 25% limit.

Defined Benefit Plans

For defined benefit plans, the contributions that are necessary to satisfy the plan's actuarial funding requirements can be deducted, even if they exceed 25% of eligible compensation. PPA liberalized the funding rules for defined benefit plans which significantly increased deductible contribution opportunities in an attempt to improve the funding status of such plans.

Combination of Plans

PPA changed the deduction rules for employers who maintain a combination of defined benefit and defined contribution plans. The previous deduction limit for combined plans was the greater of 25% of compensation or the amount necessary to fund the defined benefit plan. Where the defined benefit plan funding exceeded the 25% limit, only elective deferrals could be contributed to a defined contribution plan.

As of 2006, employers who sponsor a defined benefit plan can also contribute and deduct up to 6% of compensation for the same employees in a defined contribution plan even if the total contributions exceed 25% of compensation. The new rule allows a defined benefit plan sponsor to establish a safe harbor 401(k) plan, if desired. This would allow all participants to defer up to

the maximum dollar amount because ADP non-discrimination testing would not be required.

Example: Company X sponsors both a defined benefit and a 401(k) plan for its employees. The required annual contribution for the defined benefit plan is $100,000, which is approximately 30% of eligible compensation. Prior to PPA, contributions to the 401(k) plan would be limited to salary deferrals since they are not part of the deduction limit calculation, and no other employer contributions to the plan could be deducted. But as of 2006, the employer can make and deduct a match and/or nonelective contribution of up to 6% of eligible compensation into the 401(k) plan.

If a safe harbor notice was distributed to participants by December 1, 2006, the plan could become a safe harbor 401(k) plan for 2007, since 6% is more than enough to satisfy either the 3% nonelective or the maximum 4% match safe harbor contribution requirements.

As of 2008, defined benefit plans that are subject to the federal Pension Benefit Guaranty Corporation (PBGC) insurance program can be completely ignored in determining deduction limits for combinations of plans. That means an employer will be able to deduct up to 25% of eligible compensation in a defined contribution plan in addition to the contribution that is necessary to fund a defined benefit plan, regardless of the amount.

Conclusion

It is important to make certain each year that your plan's contributions and/or benefits are within the allowable limits. Dollar limits are adjusted periodically for cost-of-living and should be reviewed on an annual basis. New regulations have made changes in the way certain limitations are calculated. Recent increases in contribution deduction limits have provided new opportunities for retirement planning.

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