October 7, 2005

Hon. Mark W. Everson  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Proposed Regulations Under Internal Revenue Code  
Section 415

Dear Commissioner Everson:

Enclosed are comments on proposed regulations under Internal Revenue Code Section 415. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

[Signature]

Dennis B. Drapkin  
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, IRS  
Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury  
Alan N. Tawshunsky, Assistant Chief Counsel (Employee Benefits), IRS  
Vernon S. Carter, Tax Law Specialist, Office of the Associate Chief Counsel, TE/GE, IRS  
Linda S.F. Marshall, Attorney, Office of the Associate Chief Counsel, TE/GE, IRS
COMMENTS ON PROPOSED REGULATIONS
UNDER INTERNAL REVENUE CODE SECTION 415

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Wm. Scott Magargee, III of the Employee Benefits Committee of the Section of Taxation. Substantive contributions were made by Kurt L.P. Lawson, Kyle N. Brown, Elizabeth Drigotas, Norman J. Misher and Gretchen Harders. These comments were reviewed by Kurt L.P. Lawson, Committee Vice Chair, and James R. Raborn, Committee Chair. The comments were further reviewed by T. David Cowart of the Section’s Committee on Government Submissions and by Thomas A. Jorgensen, Council Director for the Committee on Employee Benefits.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal income tax rules applicable to the subject matter addressed by these comments, or have advised clients on the application of such rules, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

Contact Person: Wm. Scott Magargee, III
Phone: 215-994-2609
Email: scott.magargee@dechert.com

Date: October 7, 2005
EXECUTIVE SUMMARY

The following comments are submitted in response to the request for comments made by the Internal Revenue Service ("Service") in the Notice of Proposed Rulemaking, 70 Federal Register 31214 (May 31, 2005), published with proposed regulations issued under section 415 of the Internal Revenue Code of 1986, as amended ("Code") (the “proposed regulations”).

Section 415 of the Code was added to the Internal Revenue Code effective in 1976 by the Employee Retirement Income Security Act of 1974 ("ERISA"), and has been amended frequently thereafter. It limits benefits under, and contributions to, qualified defined benefit and defined contribution plans, as well as arrangements under sections 403(a), 403(b) and 408(k) of the Code and state and local government plans.

The current regulations, adopted in late 1980, do not reflect the majority of the amendments to section 415 of the Code made subsequent to the enactment of ERISA.

The proposed regulations are comprehensive and detailed. We commend the Department of the Treasury ("Treasury") and the Service for their extraordinary efforts in promulgating these regulations, which are intended to cover law changes as well as Service notices, revenue rulings and other less formal guidance.

Given the sheer length and complexity of the proposed regulations, we are concerned that Treasury and the Service have not provided adequate time for the practitioner community to provide meaningful input, and we urge that a formal extension of the comment period be granted. It would be unfortunate, in our view, if haste to issue new final regulations were to prevent, as a practical matter, a full discussion of the issues we and other commentators are raising.

Our recommendations are as follows:

1. We recommend that the final regulations not use the term “annual benefit accrued,” and uniformly use the term “annual benefit payable.”

2. We recommend that the final regulations, in treating benefits transferred among plans, reflect the following:

   a. We recommend that the final regulations not include in the controlled group employers that antedate the current employer.

   b. We recommend that the final regulations make it clear that the treatment of an asset/liability transfer under section 414(l) as a deemed distribution of a single sum for purposes of section 415 does not change the section 414(l) transfer requirements.

October 7, 2005
c. We recommend that the final regulations treat transfers between plans that are not combined for purposes of section 415 testing like the treatment of rollover contributions.

3. We recommend that the final regulations, in dealing with multiple annuity starting dates, reflect the following:
   
   a. We recommend that the final regulations simplify the actuarial adjustment to prior payments by using a standard interest rate, such as 5%.
   
   b. We also recommend that the final regulations avoid the effect of fluctuations in the section 417(l) interest rate by allowing use of interest rates in effect at the date of the initial distribution for subsequent distributions.
   
   c. We recommend that the final regulations provide that adjustments to prior distributions be limited to distributions before age 62 and after age 65.

4. We recommend that the listing of restorative payments that are not annual additions be stated as examples only, and not as an exclusive listing.

5. We recommend that the final regulations not include any of the proposed limitations on post-severance pay.

6. If the final regulations include the proposed limitations on post-severance pay, we recommend that they be revised in the following ways:
   
   a. We recommend that the final regulations make the exception from the section 415 limitation on post-severance pay available for payments of regular compensation and bonuses and accrued leave, regardless of when the amounts are paid.
   
   b. We recommend that the final regulations extend the exception from the section 415 limitation on post-severance pay for payments of regular compensation and bonuses to severance pay if it satisfies the safe harbor for severance pay in the ERISA regulations.
   
   c. We recommend that the final regulations exempt nonelective deferred compensation from the section 403(b) and section 457 limitations on post-severance pay.
   
   d. We recommend that the final regulations exempt governmental plans from all of the limitations on post-severance pay.
e. We recommend that the final regulations clarify the meaning of “severance from employment” in joint venture, extended leave and similar situations by adopting rules similar to the rules in Treas. Reg. §§ 1.401(a)(4)-11(d)(3)(iv) and 1.414(s)-1(f)(2)(iv).

f. We recommend that the final regulations clarify the meaning of “severance from employment” in controlled-group situations by adopting a rule similar to the rule in GCM 39824 (July 6, 1990).

g. We recommend that the final regulations clarify that contributions may be made after a participant’s death.

7. We recommend that the final regulations delete any reference to an interaction between the compensation limits under section 401(a)(17) and section 415, consistent with the statute, current regulations, legislative history and earlier pronouncements of the Service.

8. We recommend that the final regulations make it clear that elective deferral contributions may be made to a section 401(k) plan without regard to section 401(a)(17), provided all of the applicable nondiscrimination requirements are met.
A. Prop. Treas. Reg. § 1.415(b)-1(a) – Limitations for Defined Benefit Plans

1. Background

Prop. Treas. Reg. § 1.415(b)-1(a)(1) indicates that the limit of section 415(b) applies to both a participant’s annual benefit accrued and a participant’s annual benefit payable. Under the existing regulation (Treas. Reg. § 1.415-3(a)(1)), the section 415(b) limit applies to “the annual benefit … to which a participant is entitled.” Thus, without any explanation in the text or the preamble, the proposed regulations expand the reach of section 415(b) by applying the section 415(b) limit to an annual benefit accrued, in addition to an annual benefit payable. The proposed regulations have a number of examples as to how the annual benefit payable is determined. However, they do not explain what the annual benefit accrued is.

2. Discussion

The use of the term “annual benefit accrued” raises a number of questions that the proposed regulations do not answer. For example, does the annual benefit accrued take into account all benefits accrued up to the limitation year in question, or is it only the benefit accrued during that particular limitation year? Is the annual benefit accrued, as of any limitation year, reduced by benefit payments made in a prior limitation year? In testing compliance with section 415(b), is the annual benefit accrued expressed as an annual benefit paid in straight life annuity form, so that an actuarial conversion is needed if the normal form of benefit payment under the plan is expressed in another form, for example, as a life annuity with payments guaranteed for 10 years?

Moreover, we see no reason why the section 415(b) limit cannot be applied solely to the annual benefit payable. That, in effect, is what practitioners have been doing under the existing regulation. There is no need to apply the section 415(b) limit in any additional respect, such as to an annual benefit accrued.

3. Recommendation

To avoid the questions concerning the meaning of the term “annual benefit accrued” and the availability of the term “annual benefit payable” for application of the section 415(b) limit, we recommend that the final regulations not have a reference to the annual benefit accrued and that they apply the section 415(b) limit solely with respect to the annual benefit payable.
B. Prop. Treas. Reg. §§ 1.415(b)-1(b), 1.415(f)-1 – Treatment of Benefits Transferred Among Plans

1. Background

There are several ways to transfer a participant’s benefit from one plan to another, such as by rolling the benefit over, either through a traditional rollover or a direct rollover, an elective transfer between plans as permitted by the section 411(d)(6) regulations, or via a trustee-to-trustee transfer under section 414(l). The proposed regulations would establish different methodologies for reflecting amounts accrued under another plan when determining benefits payable from a plan. The proposed regulations appear to provide one methodology for handling rollover amounts, regardless of whether the rollover was a traditional rollover or a direct rollover, and another methodology for handling other transfers of benefit amounts, regardless of whether the transfer is an elective transfer or a trustee-to-trustee transfer under section 414(l).

While the proposed regulations would take different approaches, generally the benefit is taken into account for section 415 purposes only under one plan. So, for example, according to Prop. Treas. Reg. § 1.415(b)-1(b)(1)(ii), the annual benefit payable from a plan that is subject to the section 415 limits does not include the annual benefit attributable to rollover contributions. In some circumstances, however, the benefit would have to be taken into account under more than one plan.

The portion of the proposed regulations dealing with benefits transferred between plans, however, is notable in two regards. First, that portion of the proposed regulations is exceedingly complex. The provisions concerning the treatment of transferred benefits are, in our judgment, difficult to comprehend and therefore are likely to be an impediment to voluntary compliance. The uncertainty will, we believe, be particularly a problem in the context of mergers and acquisitions. Second, the proposed regulations require that, unlike the rollover rules under which benefits are subject to the limitations of section 415 under only one plan, benefits transferred between plans of unrelated employers are considered in determining the annual benefit limited by section 415 under both plans.

There are several aspects of the provisions regarding transferred benefits that deserve clarification or possible modification.

a. Prop. Treas. Reg. § 1.415(f)-1(c) expands the group of plans that are combined for section 415 purposes to include plans sponsored by a predecessor employer, a term previously not defined by regulations. Prop. Treas. Reg. § 1.415(f)-1(c) indicates, inter alia, that “a former entity that antedates the employer is a predecessor employer with respect to the participant if, under the facts and circumstances, the employer constitutes a continuation of all or a portion of the trade or business of the former entity.” The preamble to the proposed regulations indicates this expansion of the controlled group is based on section 414(a)(2) and Lear Eye Clinic, Ltd v. Commissioner, 106 T.C. 418 (1996). Prior to the issuance of these proposed regulations, however, Treasury and the Service had not published formal guidance under section 414(a) or clarified the definition of predecessor employer. We suggest that there
be a bright-line rule, rather than a facts-and-circumstances standard, so that there will be
certainty in the business community.

b. For benefits transferred between plans sponsored by unrelated employers, the proposed regulations consider the transfer to be a deemed distribution of a single sum equal to the fair market value of assets distributed. The potential impact of this requirement on benefit transfers and the assumptions used to value those benefits for purposes of section 414(l) is unclear. For example, if a participant has accrued a benefit equal to the $170,000 maximum annual benefit payable under section 415, and that benefit is then transferred to another plan, the present value of that benefit is determined using assumptions considered reasonable for purposes of section 414(l). That amount, if then treated as a single sum distribution and converted to a single life annuity using section 417(e) assumptions, could easily result in an equivalent annuity greater than the maximum benefit payable under section 415. Clarification is needed indicating that transferring assets and liabilities in a transaction complying with section 414(l) will not result in a violation of section 415 if that transfer is treated as a deemed distribution of a single sum for purposes of section 415.

c. According to Prop. Treas. Reg. § 1.415(b)-1(b)(3)(i)(B), if benefits are transferred between plans that are not combined under section 415(f) for purposes of the section 415 limits, the transferred benefit is treated as a lump sum distribution from the transferor plan equal to the fair market value of assets transferred and the benefit attributable to the transferred benefit is treated as part of the annual benefit payable from the transferee plan. Because benefits could be transferred between unrelated plans pursuant to a traditional or direct rollover, and the benefit would only be considered part of the annual benefit limited by section 415 under one plan, it is not clear to us why different treatment is appropriate for other methods of transferring benefits from one plan to another.

2. Recommendations

a. The proposed regulations effectively expand the definition of controlled group to include employers that antedate the current employer, based on a facts and circumstances test that is not well defined. We believe that it is inappropriate to expand the definition of predecessor employer, a term described in section 414(a)(2), without defining the term in guidance issued under section 414(a)(2), and we recommend that the reference to predecessor employer be eliminated from the final section 415 regulations.

b. We recommend that it be made clear that the treatment of an asset and liability transfer under section 414(l) as a deemed distribution of a single sum distribution for purposes of section 415 does not change the transfer requirements under section 414(l). If assets are transferred for a participant’s benefit that, when converted to a single life annuity using section 417(e) assumptions, exceed the maximum benefit payable under section 415, such a transfer should not be viewed as a violation of section 415 or restrict the assets transferred pursuant to section 414(l).
c. We recommend that the treatment of benefits transferred between plans that are not combined for purposes of section 415 should be clarified and treated in a fashion similar to that of rollover contributions, at least in that the benefit should be considered part of the annual benefit limited by section 415 under only one plan. It may be appropriate to treat the transferred benefit as part of the annual benefit payable from the transferee plan, because the service for which the benefit was earned is generally considered as tacking over to the transferee plan for purposes of the phase in of the limitations under section 415(b)(5). If Treasury and the Service do not think that such treatment is appropriate, it would be helpful if the policy rationale behind that decision was explained and the abuse being prevented was identified. Also, it would greatly assist compliance if the language of the proposed regulations was revised simply to make it less cumbersome and more understandable.

3. Discussion

The term “predecessor employer” is derived from section 414(a)(2), a Code provision for which Treasury and the Service have not issued formal guidance, although that provision gives clear authority for Treasury and the Service to issue such guidance. We think that it is inappropriate effectively to expand the definition of controlled group to include a predecessor employer for at least two reasons. First, if Treasury and the Service are to define what constitutes a predecessor employer, we believe it is preferable that it be in guidance issued under section 414(a), subject to public comment and hearing. Second, section 414(a)(2) indicates that service with a predecessor employer shall be treated as service with the employer in certain circumstances, not that a predecessor employer becomes part of the same controlled group as the employer. Linking service with a predecessor employer as service with the current employer was the issue in controversy in Lear Eye Clinic, not whether the predecessor employer is part of the same controlled group.

If Treasury and the Service wish to consider two employers who do not exist at the same moment in time as part of a controlled group, we recommend that such a rule be the subject of separate guidance and not combined with a massive guidance project under section 415. That having been said, the circumstances when two employers who do not exist at the same moment in time are part of a group are not well defined. Among the criteria that would need to be clarified are what degree of continuity of ownership should exist between the employers and whether the duration of the period when the different employers exist changes the analysis.

The second issue, the effect of treating the benefit transfer as a deemed distribution of a single sum equal to the fair market value of assets transferred, is unclear. If the effect is to limit future accruals and distributions from the transferor plan, but not to otherwise restrict the transfer of assets, we recommend that this be clarified. If the effect is to restrict the amount of assets that can be transferred to the transferee plan, that does not appear to be the purview of section 415. Section 414(l) governs transfers of assets and liabilities, and we recommend that the proposed section 415 regulations not impose additional restrictions on such transfers.
Finally, regarding the treatment of benefit transfers between plans that are not combined for section 415 purposes, considering the transferred benefit as part of the annual benefit subject to the section 415 limitations for both plans imposes additional compliance burdens on certain types of benefit transfers. One of the few differences between trustee-to-trustee transfers and rollovers is that, in trustee-to-trustee transfers, service with the prior employer and transferor plan tack over to the transferee plan for purposes of the phase in of the limitations under section 415(b)(5). When benefits are rolled over to another plan, prior service generally does not tack, and the maximum benefit payable from the recipient plan is determined without regard to the rollover benefit.

If this difference is part of the policy rationale behind the treatment for benefit transfers, a simpler solution may be appropriate. While it may not be possible to exclude the transferred benefit from the annual benefit tested under section 415 from the transferee plan, a rule could clarify that prior service under the transferor plan can no longer be counted under the transferor plan when the benefit has been transferred to another plan. Simply put, if the issue is whether service should count under only one plan, or under two plans, for section 415(b)(5) purposes, then the final regulations could be written to permit such service to count under only the plan that is taking the benefit into account for purposes of the section 415 limits.

C. Prop. Treas. Reg. § 1.415(b)-2 – Multiple Annuity Starting Dates

1. Background

Prop. Treas. Reg. § 1.415(b)-2 sets forth proposed rules for determining the maximum benefit payable under a defined benefit plan where distributions have occurred before the current determination date. This section will apply in a variety of situations, such as when a participant has begun to receive benefits under the plan and continues working for the sponsoring employer, thereby earning additional accruals. The section will also apply if the participant has received distributions under a separate plan that must be aggregated with the current plan for purposes of section 415 or if benefits are increased as a result of plan terms applying a cost-of-living adjustment pursuant to an increase of the dollar limit of section 415(b)(1)(A), if the plan does not provide for application of the rules of Prop. Treas. Reg. § 1.415(d)-1(a)(5).

Essentially, prior payments are accumulated with interest to the current determination date and converted to a single life annuity commencing at the current determination date. That single life annuity also must be adjusted to reflect that the participant has survived during the interim period between the prior annuity starting date and the current determination date. The single life annuity resulting from this process is then added to the single life annuity equivalent of future payments to determine whether the total benefit is less than the maximum permissible annual benefit currently payable to the participant.

Calculation of actuarially adjusted prior payments is complex and requires consideration of a variety of actuarial assumptions, which can change depending on the form of the prior distribution. Depending on whether the prior distribution was subject to section
417(e)(3) (and whether the current determination dates are in 2004 or 2005), assumptions used to adjust the prior payments can be the actuarial assumptions specified by the plan, section 417(e) assumptions, 5%, or 5.5%. It is not clear to us that all of the complexity of the process specified by the proposed regulations is necessary to prevent potential abuse.

The assumptions used to adjust the prior payments are the assumptions in effect as of the current determination date – not the assumptions that were in effect as of the initial annuity starting date. Therefore, material changes in those rates since initial distribution could significantly affect the single life annuity value of prior distributions.

For example, assume a defined benefit plan terminates in 2005 and pays a single sum distribution of $100,000 to Participant A, who is 35 years old at the time of the distribution. To keep the example relatively simple, assume that the terminating plan uses section 417(e) interest and mortality assumptions for determining early retirement benefits and lump sum distributions and that the section 417(e) interest assumption at the time of distribution is 5%. Based on a maximum single life annuity amount of $160,000 per annum payable beginning at age 62, the maximum lump sum payable at age 35 based on the foregoing facts is $510,885. Thus, Participant A has received a lump sum that is less than 20% of the maximum single sum distribution permitted under section 415(b) at the time of distribution.

If a new plan is established by the same employer under which Participant A accrues benefits, it is likely that the terminated plan must be aggregated with the new plan for purposes of section 415. Assuming that Participant A earns a benefit based on 35 years of service for the employer under the new plan and wants to begin to receive benefits at age 65, it is possible the proposed regulations would not permit the new plan to pay any benefit to the participant. Assume that the section 417(e) rate at the current determination date has increased 35 years in the future from 5% to 10%, and that the maximum benefit payable under section 415(b) has grown to $225,000 per annum.1 Under those assumptions, the maximum single life annuity payable to Participant A from the new plan is $0.

Under the proposed rules, the single life annuity value at age 65 of the prior $100,000 distribution determined at 10% interest (and the mortality table currently specified by section 417(e)) is $232,922. Because this amount exceeds the section 415(b) limit at the current determination date, no additional amount may be paid from the new plan.

Finally, the actuarial adjustment process anticipated in the proposed regulations fails to reflect the fact that the same maximum benefit applies to those who commence benefits after age 62 but prior to age 65. Therefore, anyone who earns an additional accrual after age 62 or commences a benefit after age 62 and has prior payments that need to be reflected in the

1 While it is likely the rate of inflation over a 35 year period would result in a cost-of-living adjustment to the maximum benefit under section 415(b) greater than $225,000, it is equally likely that Congress will change the statutory provisions during that time, potentially lowering the limit.
section 415 calculation will be disadvantaged relative to someone who has not received such payments.

For example, assume that Participant B attains age 62 while participating in a plan with a formula accrued benefit of $200,000, so that the maximum benefit payable from the plan under section 415(b) is limited to $160,000, and that the plan does not provide for automatic increases in retiree benefits under the safe harbor methodology for determining the adjusted benefit under section 415(d). If Participant B retires and begins to receive a distribution of her benefit of $160,000, and three years later the company decides to increase benefits for all retirees by 10%, the proposed regulations would not permit the plan to pay any additional benefit to Participant B. This is the case even if at the time the additional benefit is granted, the maximum benefit permitted under section 415(b) is $180,000.

This is because the equivalent single life annuity value of the three years of payments from age 62 to age 65 is $44,595, determined using 5% interest and current section 417(e) mortality assumptions. When added to the $160,000 single life annuity benefit that Participant B is already receiving, the total benefit will exceed the maximum benefit of $180,000 permitted by section 415(b). The policy rationale for this result is unclear, because if the plan automatically provided for increases in benefits according to Prop. Treas. Reg. § 1.415(d)-1(a)(5), Participant B’s benefit could have been increased with cost of living adjustments to the section 415(b) limit without giving increases to other plan participants.

2. Recommendations

a. The complexity of the actuarial adjustment to prior payments can be simplified by using a standard interest rate, such as the 5% rate specified by sections 415(b)(5)(E)(i), (ii), and (iii). We suggest that the process can be significantly simplified without increasing the potential for abuse.

b. The effect of fluctuations in the section 417(e) interest rate can be avoided by using the interest rates in effect at the time of the initial distribution to determine the accumulated single life annuity value at any subsequent distribution date.

c. To reflect that adjustments to the section 415(b) limit are made only for distributions before age 62 and after age 65, we recommend that the actuarial accumulation of prior distributions be made only to age 62 and after age 65, with no accumulation for the years in the interim. Thus, in the example above, there would be no equivalent single life annuity value of the three years of payments from age 62 to age 65.

---

2 The current substitution of 5.5% for 5% in section 415(b)(5)(E)(ii) for plan years beginning in 2004 and 2005 is disregarded for this purpose.
3. Discussion

The methodology for recognizing prior distributions specified by the proposed regulations is extremely complex. Substituting 5% for the various interest rates that might apply for accumulating prior payments and converting to an actuarially equivalent single life annuity would considerably simplify the process without adding the potential for significant abuse of the section 415 limits.

Use of the current section 417(e) assumptions to determine the actuarially equivalent single life annuity of a prior distribution that was subject to section 417(e) could put a participant at an advantage or disadvantage compared to other participants, depending on whether the time between the initial annuity starting date and the current determination date was a period of rising or falling interest rates. Using the section 417(e) assumptions on the annuity starting date to determine the actuarially equivalent single life annuity would keep the participant in the same position vis-à-vis the section 415(b) limit at that time. Again, it is not clear that using section 417(e) assumptions from a prior year to determine the maximum benefit payable under section 415(b) would add to the potential for significant abuse.

Finally, we recommend that the adjustment of prior payments be done in a manner that recognizes that the maximum benefit under section 415(b) is payable each year between age 62 and age 65. The simplest approach to recognizing that is to exclude the value of payments made between those ages in determining the actuarially equivalent single life annuity of the prior payments. Section 415 permits the commencement of the same annual payment at age 65 as at age 62. This benefit at age 62 clearly has an actuarial value greater than the value of the benefit with the same annual payment beginning at age 65. We believe that participants who begin to receive benefits before or during this period between the ages of 62 and 65 should not be disadvantaged because of this provision if they later earn additional benefits commencing after or during this period.

D. Prop. Treas. Reg. § 1.415(c)-1(b)(2)(ii)(C) – Restorative Payments

1. Background

Section 415(c) limits the amount of annual additions to a defined contribution plan. Prop. Treas. Reg. § 1.415(c)-1(b)(1)(i) defines the term “annual additions” and Prop. Treas. Reg. 1.415(c)-1(b)(2) describes which employer contributions will and will not be considered “annual additions.” Prop. Treas. Reg. § 1.415(c)-1(b)(2)(ii)(C) states that certain restorative payments by the employer will not be considered annual additions. It further states that such payments are “restorative” in nature only if they are made to restore losses to the plan resulting from actions by a fiduciary for which there is a reasonable risk of liability for breach of fiduciary duty under Title I of ERISA. The proposed regulation lists payments that will qualify as restorative in nature, including those pursuant to a Department of Labor (“DOL”) order, DOL’s Voluntary Fiduciary Correction Program or a court approved settlement, to restore losses to the plan on account of the breach. A distinction is drawn between these kinds of payments.
and those due “merely” to market fluctuations and other payments not made on account of a reasonable risk of liability.

2. **Discussion**

It is not clear whether the enumerated listing of payments that are restorative in nature is intended to be exclusive or only examples. Also, there are situations where payments of a restorative nature are simply to correct a mistake, where no fiduciary breach is involved, and it is not clear whether these would have to be counted as annual additions.

3. **Recommendation**

We suggest that the final regulation be written to make it clear that the listing of types of payments that are restorative is not intended to be exclusive, and that the fiduciary could conclude that payments made in good faith that are not related to a DOL order, the DOL’s correction program or a court-approved settlement are nonetheless restorative.

E. **Prop. Treas. Reg. § 1.415(c)-2(e) – Limitations on Post-Severance Pay**

1. **Background**

The proposed regulations contain limitations on the use of compensation paid after “severance from employment” under sections 415, 401(k), 403(b) and 457.

**Section 415 limitation.** The proposed regulations would amend the definition of compensation under section 415(c)(3) to exclude payments made after severance from employment (within the meaning of section 401(k)(2)(B)(i)(I)) with the employer maintaining the plan, subject to two limited exceptions. Prop. Treas. Reg. §§ 1.415(c)-2(e)(1)(ii), (3), (4). One exception would be provided for certain post-severance payments that are made within 2½ months after severance. This exception would be available only for “(A) Payments that, absent a severance from employment, would have been paid to the employee while the employee continued in employment with the employer and are regular compensation for services during the employee’s regular working hours, compensation for services outside the employee’s regular working hours (such as overtime or shift differential), commissions, bonuses, or other similar compensation; and (B) Payments for accrued bona fide sick, vacation, or other leave, but only if the employee would have been able to use the leave if employment had continued.” The exception would not be available for ordinary severance pay. Prop. Treas. Reg. § 1.415(c)-2(e)(3)(iii).

A second exception would be provided for “payments to an individual who does not currently perform services for the employer by reason of qualified military service (as that term is used in section 414(u)(1)) to the extent those payments do not exceed the amounts the individual would have received if the individual had continued to perform services for the employer rather than entering qualified military service.” Prop. Treas. Reg. § 1.415(c)-2(e)(4).
Section 401(k) limitation. The proposed regulations would provide that a cash or deferred arrangement ("CODA") will be a qualified CODA if cash or deferred elections can be made only with respect to amounts that are compensation within the meaning of section 415(c)(3) and Treas. Reg. § 1.415(c)-2, i.e., not including most forms of post-severance pay. Prop. Treas. Reg. § 1.401(k)-1(e)(8).

Section 403(b) limitations. In 2004, Treasury and the Service issued proposed regulations that would provide that the exclusion from gross income for contributions to a section 403(b) contract does not apply to contributions made for "former employees," other than contributions with respect to compensation that would otherwise be paid for a payroll period that begins before severance from employment, except as permitted by the five-year look-back rule in section 403(b)(3). The new proposed regulations would incorporate by cross-reference the limited exceptions found in the proposed section 415 regulations described above. Prop. Treas. Reg. § 1.403(b)-3(b)(4)(ii).

Section 457 limitations. In 2003, Treasury and the Service adopted new final regulations under section 457. The regulations specifically allow a participant to elect to defer accumulated sick pay, accumulated vacation pay, and back pay under an eligible deferred compensation plan if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month. Treas. Reg. § 1.457-4(d). The regulations imply, and the preamble states, that this rule is an illustration of a more general rule that deferral elections under an eligible deferred compensation plan can be made only "during employment." 68 Fed. Reg. 41230, 41231 (July 11, 2003). The regulations also imply that this rule applies to nonelective deferrals, as well, if they involve salary reduction. Treas. Reg. §§ 1.457-4(b) (last sentence), (d)(2), Example 3.

The proposed regulations would make it more clear that the rule on sick, vacation and back pay is an example of a broader rule generally prohibiting deferral elections with respect to post-severance pay. However, they would incorporate by cross-reference the limited exceptions found in the proposed section 415 regulations described above. Prop. Treas. Reg. § 1.457-4(d)(1).

Because section 457(e)(5) provides that the term "includible compensation" has the same meaning for purposes of the 100%-of-compensation limits on annual deferrals under an eligible deferred compensation plan as the term "compensation" in section 415(c)(3), the

* The proposed regulations would not define a “former employee” but would define an “employee” as “a common-law employee performing services for the employer” and add that the term does not include a former employee or an independent contractor. It is not clear whether an employee would become a former employee when he or she ceased to perform services for the employer – in which case the reference to a former employee in the definition would serve as a mere example of the general rule – or at some other point.
proposed regulations also would exclude most forms of post-severance pay from the calculation of compensation for purposes of those limits.

2. **Recommendations**

   a. We recommend that the final regulations not include any of the proposed limitations on post-severance pay.

   b. If the final regulations include the proposed limitations on post-severance pay, we recommend that they be revised in the following ways:

   i. We recommend that the final regulations make available the exception from the section 415 limitation on post-severance pay for payments of regular compensation and bonuses and accrued leave regardless of when the amounts are paid.

   ii. We recommend that the final regulations extend the exception from the section 415 limitation on post-severance pay for payments of regular compensation and bonuses to severance pay if they satisfy the safe harbor for severance pay in the ERISA regulations.

   iii. We recommend that the final regulations extend the exception from the section 415 limitation on post-severance pay for payments of regular compensation and bonuses to back pay and comp time.

   iv. We recommend that the final regulations exempt nonelective deferred compensation from the section 403(b) and section 457 limitations on post-severance pay.

   v. We recommend that the final regulations exempt governmental plans from all of the limitations on post-severance pay.

   vi. We recommend that the final regulations clarify the meaning of “severance from employment” in joint venture, extended leave and similar situations by adopting rules similar to the rules in Treas. Reg. §§ 1.401(a)(4)-11(d)(3)(iv) and 1.414(s)-1(f)(2)(iv).

   vii. We recommend that the final regulations clarify the meaning of “severance from employment” in controlled-
group situations by adopting a rule similar to the rule in GCM 39824 (July 6, 1990).

viii. We recommend that the final regulations clarify that contributions may be made after a participant’s death.

3. Discussion

Our reasons for making these recommendations are set forth below.

a. Recommendation not to include any limitations. The preamble to the proposed regulations describes the rules regarding the treatment of post-severance pay as “guidelines,” suggesting that they are intended to explain existing law. However, we believe there is no doubt that they impose new limitations. For example, the existing regulations specifically allow unfunded nonqualified deferred compensation to be treated as compensation for purposes of section 415. Treas. Reg. § 1.415–2(d)(3)(i). The Service also takes the position that severance pay is subject to federal income tax withholding and must be reported on Form W-2, regardless of when it is paid. See, e.g., Rev. Rul. 73-166, 1973-1 C.B. 411. Thus, severance pay fits within both of the safe harbor definitions of compensation in Treas. Reg. § 1.415-2(d)(11), and according to Treas. Reg. § 1.415-2(d)(1) may be treated as compensation for purposes of section 415, as well. Yet the proposed regulations would prohibit either nonqualified deferred compensation or severance pay from being treated as compensation unless it was paid before severance from employment. Prop. Treas. Reg. § 1.415(c)-2(e)(3)(iii).

The preamble to the proposed regulations does not explain why the new limitations are needed. We have heard several arguments and can imagine several others. However, in our view none of them is persuasive.

Meaning of “compensation.” One argument is simply that the best interpretation of “compensation” in section 415, and the same or related terms in sections 401(k), 403(b) and 457, is that it excludes pay received after severance from employment. However, “compensation” for tax purposes usually means amounts received for services, and all payments made by an employer to an employee are, ultimately, remuneration for the employee’s services, whether the employee is actively at work or not. No rational employer would voluntarily pay anything more. Even deferred compensation is still “compensation.” Moreover, in our view nothing in the phrasing or history of these provisions suggests that a narrower definition of compensation (or related terms) was intended.

Section 415. Section 415(c)(3) generally defines a participant’s compensation as “the compensation of the participant from the employer for the year” plus certain specified elective deferrals and contributions. The legislative history states that that compensation for purposes of section 415(b) “includes the participant’s earnings from his employment and includes bonuses and other taxable payments except for deferred compensation, stock options, and other distributions which receive special tax benefits.” H.R. Rep. No. 93-807, at 119-121 (1974). We note that this language refers to “earnings from employment” not “earnings during
employment,” suggesting that it is the source of earnings, not their timing, that is important. As already mentioned, the existing regulations, which were first issued in 1980, interpret this statement to allow unfunded nonqualified deferred compensation to be treated as compensation for purposes of section 415. The legislative history also explains that “[t]he purpose of [section 415] is to prevent the accumulation of excessive pension benefits out of tax-free dollars.” More specifically, it states that the compensation prong of the limit in section 415(b) is needed because “a pension is essentially a substitute for earning power during retirement years,” and that the limits in section 415(c) are needed “to achieve some measure of comparability with the limitations imposed on the benefits which may be paid under a defined benefit plan.” *Id.*

We think this means that section 415 was intended allow a plan to provide a standard of living to a participant after retirement that is as great as but no greater than the standard of living he or she was able to achieve during his or her working life. Accordingly, while it is appropriate to exclude certain income that is clearly retirement income from section 415 compensation, as the existing regulations do, there is no justification for excluding other income that reflects the individual’s earning power during his or her working life merely because it happens to be received when the individual is not currently performing services for a particular employer. Consider, for example, a worker who participates in a defined benefit plan that bases benefits on high-three year compensation. The worker receives a significant raise, but two years later his plant is closed. If the employer wants (or is obliged under a severance pay plan, the WARN Act, a bargaining agreement, etc.) to continue wage payments for an additional year, how can it be inconsistent with the purposes of section 415 to allow the worker to receive a comparable amount in benefits when he finally retires?

*Section 401(k).* Section 401(k) does not place any restrictions at all on the kinds of income that can be subject to a qualified CODA. It does not even require the income to be compensation for services. Code § 401(k)(2)(A); Treas. Reg. §§ 1.401(k)-1(a)(3)(i)(A) (2004 and 1994 versions). Some nondiscrimination rules existed under an earlier version of the regulations, see Treas. Reg. § 1.401(k)-1(g)(9) (1988 version), but these were deliberately eliminated when the regulations were revised in 1991.

4 Of course, the contribution percentages that are used to apply the actual deferral percentage (“ADP”) test in section 401(k)(3) and the employer contributions that are required to satisfy the safe harbors in sections 401(k)(11) and (12) are based on participants’ compensation within the meaning of section 414(s). Section 414(s) compensation can include compensation from a prior employer and imputed compensation during periods when the individuals are not performing services for the employer (including periods when they are performing services for another employer, e.g., a joint venture) or are working on a reduced work schedule. See Treas. Reg. §§ 1.414(s)-1(d), (e), (f). Elective contributions under the safe harbors must be made from section 414(s) compensation, as well, but without regard to the nondiscrimination requirement in Treas. Reg. § 1.414(s)-1(d)(3). See Treas. Reg. § 1.401(k)-3(c)(6)(iv); Notice 98-52, 1998-46 I.R.B. 16.

October 7, 2005
**Section 403(b).** Section 403(b) is no more restrictive. Like section 401(k), section 403(b) does not place any restrictions at all on the kinds of income that can be subject to a deferral election. Employer contributions are subject to section 415, like allocations under a tax-qualified plan. A different definition of compensation – “includible compensation” – is used for that purpose, but it is no more restrictive than the usual definition of section 415 compensation. In fact, it defines includible compensation to include amounts received by a former employee up to five years after he or she last performed services for the employer. Code section 403(b)(3).

**Section 457.** The situation under section 457 is similar. Like section 401(k), section 457 does not place any restrictions at all on the kinds of income that can be subject to a deferral election. Contributions are limited to 100% of the participant’s includible compensation, which has the same meaning for this purpose as the term “compensation” in section 415(c)(3). In our view, nothing in this rule suggests that the definition of compensation was intended to exclude post-severance pay.

**Exclusive benefit rule.** Another argument is that the limitations on post-severance pay provide a backstop to the exclusive benefit rule. Section 401(a) provides that a trust is a qualified trust only if it is part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries. The same exclusive benefit rule applies to section 403(a) qualified annuity plans. The exclusive benefit rule “is designed to prohibit the use of plan assets for the benefit of anyone other than the employees and their beneficiaries,” GCM 39267 (Aug. 2, 1984), in particular plan sponsors and fiduciaries, see, e.g., Rev. Rul. 73-380, 1973-2 C.B. 124; *Ma-Tran Corp. v. Commissioner*, 70 T.C. 158 (1978), employees not covered by the plan, see, e.g., Rev. Rul. 73-528, 1973-2 C.B. 13, and employees of unrelated employers, see, e.g., Rev. Proc. 2002-21, 2002-1 C.B. 911.

In our view, nothing in the language or history of the requirement (or the similar requirement in section 403(c)(1) of ERISA) suggests that the reference to “employees” was intended to prevent the use of plan assets for the benefit of former employees, much less individuals who simply are not performing services for the employer but remain employees. Indeed, the regulations state that “A plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave, as, for example, in the Armed Forces of the United States. A plan covering only former employees may qualify under section 401(a) if it complies with the provisions of section 401(a)(3)(B), with respect to coverage, and section 401(a)(4), with respect to contributions and benefits, as applied to all of the former employees.” Treas. Reg. § 1.401-1(b)(4); see also Rev. Rul. 72-180, 1972-1 C.B. 107.\(^5\) Also, former employees who are

---

5 In Rev. Rul. 73-238, 1973-1 C.B. 193, the Service concluded that a pension plan violates the exclusive benefit rule if it allows terminated employees not on a leave of absence to continue to accrue benefits under the plan. However, in a preamble to the section 401(a)(4) regulations permitting the imputation of service under certain circumstances,
permanently and totally disabled participants in defined contribution plans, if they are not highly compensated employees, can receive employer contributions based upon their last rate of pay before disability under section 415(c)(3).

**Meaning of “employee.”** Another argument is that the limitations on post-severance pay are consistent with the references to “employee” in sections 415, 401(k) and 403(b), and “individuals who perform service for the employer” in section 457. However, in our view nothing in the history of section 415 suggests that “employee” means anything different in that section than it does in the exclusive benefit rule, for example that it excludes former employees or employees not performing services. See, e.g., H.R. Rep. No. 93-807, at 119-121 (1974). Similarly, nothing in the history of section 401(k) or section 403(b) suggests that the references to “employee” in those section were intended to make coverage under qualified CODAs any more restrictive vis-à-vis those employees than coverage under the tax-qualified plans of which they are a part, or to make coverage under section 403(b) contracts any more restrictive than coverage under the section 403(a) qualified annuity plans on which they were based. See, e.g., H.R. Conf. Rep. No. 95-1800, at 206-07 (1978), reprinted in 1978-3 (Vol. I) C.B. at 540-41; Staff of the Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, at ___ (1979); S. Rep. No. 85-1983, at ___ (1958), reprinted in 1958-3 C.B. at 956-57. Finally, nothing in the history of section 457 suggests that the reference to “individuals who perform service for the employer” in that section was intended to do anything more than exclude partnerships and corporations and make sure that the income being deferred is compensation income. See, e.g., S. Rep. No. 95-1263, at 36-71 (1978), reprinted in 1978-3 C.B. (Vol. I) at 361-69.

Moreover, in the case of section 401(k), such an argument would be inconsistent with the existing regulations. The regulations under section 410(b) define an “employee” to include any individual receiving allocations to his or her account under a defined contribution plan (other than mere allocations of income, expenses, gains and losses), and any individual being credited with accruals under a defined benefit plan that are based on ongoing service or the Treasury and Service expressed doubts about the continuing validity of the ruling. See 58 Fed. Reg. 3876, 3878 (Jan. 12, 1993).

Section 401(k)(2) generally defines a qualified cash or deferred arrangement as an arrangement under which a covered employee may elect to have the employer make payments either as contributions on behalf of the employee to a tax-qualified profit sharing or stock bonus plan, or to the employee directly in cash. Section 403(b)(1) provides that the exclusion from gross income for contributions to a section 403(b) contract generally is available only if the contract is purchased for an employee by a specified tax-exempt employer. Section 457(b)(1) provides that the only individuals who may participate in an eligible deferred compensation plan are individuals who perform service (including service as an independent contractor) for the employer that established and maintains the plan.
compensation credits, in both cases regardless of whether the individual is a current employee. Treas. Reg. § 1.410(b)-9. This definition is cross-referenced in a variety of other sections of the regulations, including the regulations under section 401(k). See Treas. Reg. §§ 1.401(k)-5 (2004 version) and 1.401(k)-1(g)(5) (1994 version). It is difficult to see how restrictions on post-severance pay under section 401(k) could be justified on the basis that individuals who have had a severance from employment are no longer “employees” when the regulations under that very section treat such individuals as employees to the extent they continue to receive allocations under the CODA.

Similarly, in the case of section 403(b), such an argument would lead to a result that is inconsistent with the statute. As noted above, section 403(b)(3) allows contributions to a section 403(b) contract on behalf of a former employee to be based on compensation for his or her most recent “year of service,” which may precede the calendar year for which the contribution is being made by as much as five years. Here again, it is difficult to see how restrictions on post-severance pay under section 403(b) could be justified on the basis that individuals who have had a severance from employment are no longer “employees” when section 403(b) itself allows such individuals to continue to participate for up to five years after severance from employment.

**Simplification.** Another argument is that the limitations on post-severance pay simplify plan administration by allowing plan administrators to cut off active plan participation by departing employees at the same time – severance from employment – as they make distributions to them. However, this overlooks four things:

First, the severance from employment standard is not particularly clear. It is modeled after the “severance of employment” standard that applies to distributions from section 401(a) plans, see Treas. Reg. § 1.401-1(b)(1)(ii) (profit-sharing plans); Rev. Rul. 56-693, 1956-2 C.B. 282 (pension plans). That standard was interpreted in 1990 as not incorporating a “same desk” rule, see GCM 39824 (July 6, 1990), thus reversing the Service’s conclusion in an earlier private letter ruling, see PLR 8614060 (Jan. 13, 1986), in part in response to employer concerns about the burden of maintaining accounts for employees who went to work for other employers after corporate transactions. In 2001, Congress replaced the “separation from service” standard in sections 401(k), 403(b) and 457 with the severance from employment standard so that the same desk rule would not apply under those sections. See H.R. Conf. Rep. No. 107-84, at 256-57 (2001) (“EGTRRA Conference Report”). Thus, it is clear that an employee can experience a severance from employment as a result of a corporate transaction even if he or she continues to

---

7 For some reason GCM 39824 described Rev. Rul. 56-693 as imposing a severance “from” employment standard (rather than a severance “of” employment standard) and proceeded to interpret that standard. Thus, GCM 39824 might be the ultimate source of the severance from employment standard.

8 The Employee Benefits Committee’s Task Force on Separation from Service submitted comments on this issue on January 7, 1988.
work at his or her old job. See Notice 2002-4, 2002-1 C.B. 298. However, that is virtually the only thing that is clear under the severance from employment standard. It is not clear, for example, whether a severance from employment occurs when an employee switches to a different job with the same employer, leaves and returns within a short period of time, or takes an unpaid leave of absence. Cf. Rev. Rul. 69-647, 1969-2 C.B. 100; Barrus v. United States, 23 A.F.T.R. 2d 990 (D.N.C. 1969); Edwards v. Commissioner, 57 T.C.M. 1217 (1989) (similar issues under separation from service standard).

Second, the severance of employment standard under section 401(a) is permissive, i.e., employers are free to require participants to meet more restrictive standards in order to receive distributions, see, e.g., EGTRRA Conference Report at 257 (“The conferees intend that a plan may provide that specified types of severance from employment do not constitute distributable events”), and plan administrators can be given the discretionary authority to apply those standards in appropriate ways depending on the facts. By contrast, the proposed regulations would make compliance with the severance from employment standard a qualification requirement for section 401(a) and 457 plans and section 403(b) annuities. If a plan administrator applies the standard honestly but incorrectly in a particular situation, dire consequences could result.

Third, as explained above, the severance from employment standard was adopted for the convenience of employers. We think that by imposing that standard in other areas, on a mandatory basis, the proposed regulations could have the unfortunate effect of discouraging employers who would otherwise be inclined to do so from providing benefits as broadly as possible.

Finally, section 415(h) states that, for purposes of sections 415(b) and (c), the controlled-group rules are applied using a 50% rather than the usual 80% standard of control. Thus, a move to a 50% - 79% subsidiary could potentially be a severance from employment for purposes of section 401(a) but not for purposes of section 415.

Nondiscrimination. Another argument is that the limitations on post-severance pay make retirement plans less discriminatory because post-severance pay is disproportionately provided to highly compensated employees. We are not aware of any studies that would back up such a claim. We also think that any such discrimination would be discrimination with respect to wages, something that is permitted, not discrimination with respect to benefits. Applying the same logic, plans should not be allowed to take bonuses into account under section 415 or allow employees to defer them under section 401(k), section 403(b) or section 457 because bonuses are disproportionately provided to highly compensated salaried employees. Finally, to the extent that discrimination with respect to benefits is a serious concern, we think that a nuanced approach like the one taken in the regulations under sections 401(a)(4) and 414(s) with respect to imputed service and compensation, see Treas. Reg. §§ 1.401(a)(4)-11(d)(3)(iv) and 1.414(s)-1(f)(2)(iv), would be more appropriate given the variety of post-severance pay and situations for providing it than the inflexible approach in the proposed regulations.
b. **Recommendation to modify the limitations if they are included.**

If the final regulations include the proposed limitations on post-severance pay, we recommend that they be revised in the following ways:

i. **Eliminate the 2½-month limit.**

   We think that it is unreasonable to expect payroll departments to process all payments of regular and bonus compensation and accrued leave within 2½-months after severance from employment and we see no reason to require them to do so. The limit appears to have been borrowed from sections 404(b) and 409A, where it is used to distinguish deferred compensation from current compensation. However, under those sections the 2½-month period does not begin until the end of the employer’s taxable year, and the only consequences of violating the rule are more stringent deduction rules (under section 404(b)) and certain design constraints (under section 409A), not the complete elimination of a category of compensation from pensionable earnings. Even when it starts at the end of the year, the period is often too short to process bonus compensation. Moreover, we think that the regular and bonus compensation and accrued leave described in the regulation are by their nature forms of current compensation rather than deferred compensation, and see no reason to require additional proof of that fact.

ii. **Extend the regular and bonus compensation exception to severance pay.**

   We see no compelling reason to exclude severance pay from the exceptions in Prop. Treas. Reg. § 1.415(c)-2(e)(3) completely. Severance pay is nothing but a short-term substitute for regular compensation that an employee would have received but for an unexpected layoff or other period of unemployment. In many cases it is indistinguishable from regular compensation, such as when an employer allows an employee to remain on the payroll for a period of time after ceasing to perform services or substantially reducing his or her hours while looking for another job. In other cases it is paid in lieu of regular compensation, such as when an employer pays an employee a certain number of weeks’ pay to avoid having
to give him or her the same number of weeks’ advance notice of termination.

However, we understand that the larger a severance payment is, and the longer it is paid, the more concern Treasury and the Service might have that it is really a form of retirement income and not appropriate to include in compensation for section 415 or other purposes. Therefore, we suggest that the exception for severance pay be limited to severance pay that satisfies the ERISA safe harbor in 29 C.F.R. § 2510.3-2(b), or the proposed exception for separation pay in the proposed regulations under section 409A, Prop. Treas. Reg. § 1.409A-1(b)(9)(iii). 9

iii. **Extend the regular and bonus compensation exception to back pay and comp time.**

Similarly, we think that back pay and comp time, and other amounts paid in lieu of regular and bonus compensation, deserve to be treated the same as regular and bonus compensation for purposes of the exceptions in Prop. Treas. Reg. § 1.415(c)-2(e)(3). These amounts compensate employees (primarily rank and file) for regular or bonus compensation that should or would have been paid had they been working but were not for a variety of reasons that have little potential for abuse.

iv. **Exempt nonelective deferred compensation from the section 403(b) and section 457 limitations.**

It is not clear whether Treasury and the Service intend the section 403(b) and section 457 limitations on post-severance pay to apply to nonelective as well as elective deferrals. The section 401(k) limitation by its nature would apply only to elective deferrals. The section 403(b) and section 457 limitations read as if they would apply to both, but, if so, the effect would be to impose

---

9 We would like to point out that one of the conditions for the section 409A exception to apply is that the payments may not exceed the lesser of two times the service provider’s annual compensation or two times the applicable section 401(a)(17) limitation. This condition is automatically satisfied by any severance pay that would be taken into account for section 415 purposes, because section 401(a)(17) would apply to such pay directly.
much stricter limitations on section 403(b) arrangements and section 457 plans (i.e., prohibiting them from basing nonelective deferrals on any post-severance pay, rather than merely tightening the overall limits that apply to such deferrals) than on section 401(a) plans. We think that would be unfair.

v. **Exempt governmental plans from the limitations.**

The limitations on post-severance pay appear to reflect a concern about discrimination. Congress has recognized that discrimination concerns rarely arise in governmental plans and therefore has exempted them from most of the nondiscrimination requirements in the Code. See Code §§ 401(a)(5)(G), 403(b)(12)(C), and 410(c). We think that it would be consistent with this approach to exempt governmental plans from all of the limitations in the proposed regulations on post-severance pay as well.

vi. **Clarify the meaning of “severance from employment” in joint venture, extended leave and similar situations.**

As noted above, the severance from employment standard is no clearer in many respects than the separation from service standard that it replaced. In particular, it is difficult to determine with certainty when a severance from employment occurs in a joint venture, extended leave or similar situation where an employee has ceased to perform services for the employer but continues to be treated as an employee for certain purposes and/or the parties expect that he or she will return. The regulations under sections 401(a)(4) and 414(s) address a very similar issue, namely under what circumstances the employee’s relationship with the employer remains close enough that it is appropriate, and unlikely to lead to abuse, to allow a plan to impute service and compensation in such a situation. See Treas. Reg. §§ 1.401(a)(4)-11(d)(3)(iv) and 1.414(s)-1(f)(2)(iv). We recommend that similar rules be adopted if the

---

10 We assume that Treasury and the Service do not consider a severance from employment to have occurred any time an employee ceases to perform services, although unfortunately this is the implication of the limited exception provided for “payments to an individual who does not currently perform services for the employer by reason of qualified military service”. October 7, 2005
limitations on post-severance pay are retained in the final regulations. Among other things, such rules would provide that:

- The limitations apply only if the individual has permanently ceased to perform services as an employee for the employer maintaining the plan (or any other person considered part of the same employer under sections 414(b), (c), (m) or (o)), i.e., is not expected to resume performing services as an employee for the employer. *Cf.* IRS Information Letter to Sen. Paul Sarbanes (Sept. 6, 2000) (“to receive a distribution from a [retirement] plan on account of a separation from service, the participant must have experienced a bona fide termination of employment in which the employer/employee relationship is completely severed”).

- Whether an individual has permanently ceased to perform services as an employee for an employer is determined taking into account all of the relevant facts and circumstances.

- There is a rebuttable presumption for a period of up to two years that an individual who has ceased to perform services as an employee for an employer is nonetheless expected to resume performing services as an employee for the employer if the employer continues to treat the individual as an employee for significant purposes unrelated to the plan.

- The limitations do not apply in the case of an individual who is not performing services for the employer because of disability or is performing services for another employer under an arrangement (such as a transfer of the employee to another employer) that provides some ongoing business benefit to the original employer.

vii. **Clarify the meaning of “severance from employment” in controlled group situations.**

The proposed regulations would amend the definition of compensation under section 415(c)(3) to exclude payments made after severance from employment within the meaning of section 401(k)(2)(B)(i)(I) with “the
“employer maintaining the plan.” The quoted phrase often is used to mean the corporation or other legal entity that actually sponsors the plan, see, e.g., Treas. Reg. § 1.410(b)-9 (definition of "employer"), although in this context we assume it means the controlled-group employer as defined in Prop. Treas. Reg. § 1.415(a)-1(f)(1) that includes that entity. To avoid confusion, we recommend that the final regulations include a more specific statement similar to one in GCM 39824 that, in determining whether the employment relationship with the employer maintaining the plan has been severed for purposes of section 401(a), the employer includes all members of any controlled group as defined in section 414(b), partnerships, proprietorships, etc. under common control as defined in section 414(c), and members of an affiliated service group as defined in section 414(m), of which the employer maintaining the plan is a member.\footnote{The rule in Prop. Treas. Reg. § 1.415(c) - 2(g)(2) does not address the same issue.}

We also recommend that the final regulations clarify that, consistent with section 415(h), a 50\% standard of control is used rather than the usual 80\% standard of control for this purpose.

viii. **Clarify that contributions may be made after an employee’s death.**

We understand that, recently, Service representatives have informally questioned whether a contribution that an employee has the right to receive under a section 403(b) arrangement may be made after an employee’s death where the employee terminates employment on account of death, or dies during the five-year period. We believe that the answer is clearly “yes” and that any other result would violate the vesting rules for ERISA plans. Therefore, we recommend that the final regulations clarify that amounts, all rights to which have accrued under the plan on or before termination of employment, may be contributed by the employer to such plan, subject to the relevant section 415 limits for the limitation year, even if the participant dies at or subsequent to the termination of employment, provided that such contributions are timely made in accordance with the
current Code and ERISA deadlines for employer contributions.

F. **Prop. Treas. Reg. § 1.415(c)-2(f) – Interaction with Section 401(a)(17)**

1. **Background**

The proposed regulations would apply the compensation limit of section 401(a)(17) in determining a participant’s maximum accrued benefit under section 415. The specific proposed regulation would state:

“(f) Interaction with section 401(a)(17). Because a plan may not base allocations (in the case of a defined contribution plan) or benefit accruals (in the case of a defined benefit plan) on compensation in excess of the limitation under section 401(a)(17), a plan’s definition of compensation for a limitation year that is used for purposes of applying the limitations of section 415 is not permitted to reflect compensation for a plan year that is in excess of the limitation under section 401(a)(17) that applies to that plan year.” Prop. Treas. Reg. § 1.415(c)-2(f).

The basis for the application of section 401(a)(17) to section 415 is not evident from a close reading of both of the sections and the related regulations. Moreover, the general understanding among practitioners has been that the section 401(a)(17) limit was to be applied in determining the amount of a participant’s accrued benefit, and not the maximum benefit that could be paid under section 415. Treasury and the Service agreed with this view during the exchange of technical questions and answers with the American Bar Association’s Joint Committee on Employee Benefits in 1996.

The Preamble to the proposed regulations does not discuss the basis for what would be a new position of Treasury and the Service, other than to indicate that: “. . . the proposed regulations under § 1.415(c)(2) would clarify the interaction of the requirements of section 401(a)(17) and the definition of compensation that must be used for purposes of determining a participant’s average compensation for the participant’s high 3 consecutive years.” [Emphasis supplied]

The Preamble, Background section, Overview, C. Determination of high 3 average compensation, also states that this and another change “. . . would have a significant effect on the determination of a participant’s average compensation for the participant’s high 3 consecutive years.” [Emphasis supplied] This suggests that Treasury and the Service recognize that the proposed regulation would represent a new position.\(^\text{12}\)

---

\(^{12}\) The American Society of Pension Professionals and Actuaries (ASPPA) in its July 25, 2005 comment letter on the proposed regulations, sets forth the history of this issue.
Treasury and the Service’s proposed new position, if made final, would work a hardship on older participants. The example in the Preamble makes this point. A participant’s benefit does not begin until her age 75, presumably because she does not retire until then, but the application of the section 401(a)(17) limits caps her benefit well below what it would have grown to under the adjusted dollar limitation between normal retirement age 65 and age 75.

“Thus, for example, where a participant commences receiving benefits in 2005 at age 75 (so that the adjusted dollar limitation could be as high as $379,783), and the participant had compensation in excess of the applicable section 401(a)(17) limit for 2002, 2003 and 2004, the participant’s benefit under the plan is limited by the average compensation for the highest three years as limited by section 401(a)(17) (i.e., $201,667, or the average of $200,000, $200,000 and $205,000).”

This participant would have been far better off had the plan provided for benefit payments beginning at age 65 rather than at later retirement.

Treasury and the Service’s proposed new position would be a trap for the unwary.

2. Recommendations

We recommend that the final regulations not contain any reference to an interaction between the section 401(a)(17) compensation limit and the benefit limits under section 415.

G. Prop. Treas. Reg. § 1.401(k)-1(e)(8) – Coordination among Sections 415, 401(a)(17) and 401(k).

1. Background

The proposed regulations can be read to suggest that a qualified cash or deferred arrangement must provide that the method by which deferrals are made under the plan takes into account only section 401(a)(17) compensation. This is opposed to the interpretation that section 401(a)(17) compensation is used only as the method by which deferrals must be tested for compliance with the nondiscrimination requirements of section 401(k).

Compliance with section 401(a)(17) would be an issue of significance for section 401(k) plan sponsors. Rather than adding the cross-reference to section 401(a)(17), we suggest that this point be clarified through additional guidance in the context of section 401(k).

2. Recommendations

We recommend that the final regulations clarify that a section 401(k) plan is permitted to provide for election of deferrals without regard to section 401(a)(17) compensation,
provided that all applicable nondiscrimination requirements must be satisfied using only compensation as limited by section 401(a)(17).

3. Discussion

The proposed regulations include a proposed change to the regulations under section 401(k) that would add as a requirement to be a qualified cash or deferred arrangement that “cash or deferred elections can only be made with respect to amounts that are compensation within the meaning of section 415(c)(3) and § 1.415(c)-2.” Treas. Reg. § 1.415(c)-2 includes reference to coordination with section 401(a)(17), in subsection (f), which states that “Because a plan may not base allocations (in the case of a defined contribution plan) . . . on compensation in excess of the limitation under section 401(a)(17),” the definition of compensation used for purposes of section 415 cannot exceed compensation that exceeds section 401(a)(17). As discussed above, we disagree that the limitations of section 415 need to be coordinated with the limitations of section 401(a)(17) in this manner. Inclusion of this cross-reference would create confusion in section 401(k) plan administration, and we believe this should be clarified more directly.

It is, of course, correct that a defined contribution plan, including a section 401(k) plan, cannot provide for allocations based on a definition of compensation that does not comply with section 401(a)(17). Compensation as limited by section 401(a)(17) is used for purposes of determining compliance with the nondiscrimination requirements under section 401(k) and section 401(m), i.e., calculation of actual deferral percentage ratios, and contributions subject to section 401(m), calculation of actual contribution ratios, must be done using only compensation that, as defined in Treas. Reg. § 1.401(k)-6, is limited by section 401(a)(17).

What is not clear is what this means for a section 401(k) plan with respect to the administrative method by which deferrals are taken out of employee payroll. For example, assume a plan that allows employees to elect to defer up to 50% of compensation, with the employee allowed to change elections periodically throughout the year. The employee’s election is applied to any compensation earned during that period, without regard to what amounts the employee otherwise has or is expected to earn during the year. The central question is whether this provision is permissible, or whether the plan is required to preclude an employee from making additional elective deferrals once the employee has earned compensation equal to the section 401(a)(17) limit for the year, or to somehow apply deferral elections against only a portion of compensation for a period.

There is no requirement under either the current regulations or the recently finalized regulations under section 401(k) that requires the method by which deferrals are calculated to use a definition of compensation that is somehow coordinated with section 401(a)(17), nor can we find any reason to impose such a requirement. In general, section 401(a)(17) operates with respect to compensation on an annual basis. Treas. Reg. § 1.401(a)(17)-1(a)(3). Specific rules related to partial year compensation do not apply when the full year’s compensation is used, or when there is partial year compensation due to participation during only a portion of the year.
To take the example of the plan above, applying a percentage election against all payroll compensation is simply a method of calculating the dollars of the deferral. In no event can the plan operate to allow higher deferrals by a more highly compensation employee, due to the limitations of sections 401(a)(31) and 402(g), and the applicable nondiscrimination requirements. To force a plan to stop deferrals once an individual has earned compensation equal to the section 401(a)(17) compensation limit would force affected individuals to elect higher deferrals during the beginning of the year, but would not otherwise affect the amount that could permissibly be deferred under the plan.

Given the focus brought to this issue by the proposed change to the section 401(k) regulations, it is appropriate instead to address the issue more directly by providing that annual compliance must include limiting compensation taken into account in accordance with section 401(a)(17), but that such section does not affect the method by which the deferred amounts are calculated and contributed. Doing so would eliminate administrative uncertainty.

* * *

CONCLUSION

We commend the Treasury and the Service for taking on the arduous task of updating the regulations under section 415, and with some exceptions we think that the proposals would greatly improve the existing regulations. However, the exceptions are important. We think that some aspects of the proposals would add significantly to the complexity of plan testing and administration, as for example in the case of the multiple annuity starting date rules. We also think that in certain respects there is a lack of authority or compelling need for the proposals, as in the case of the new limitations on post-severance pay. There are still other areas where we think the proposals would conflict with the way the statute has historically been interpreted, as for example in the case of the newly established interaction between section 415 and section 401(a)(17). For these reasons we urge Treasury and the Service to reconsider the proposed rules to reduce complexity and more closely align them with published authority.