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CLIENT ACTION BULLETIN



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IRS Proposes Rules on Retirement Plan Benefits and Contributions

SUMMARY The IRS has released proposed rules on the limitations on benefits and contributions for retirement plans, putting together in one comprehensive document numerous statutory and regulatory pronouncements that have been issued since 1981. The new regulations may affect the amounts that can be contributed to or paid from the plan, as well as the amounts to fund a defined benefit plan. The rules also provide new guidance for certain special situations and for a common approach to plan design: incorporating the limits into a plan document by reference versus specifying limits within the plan itself.

The proposed regulations generally would apply to limitation years (calendar year, for most plans) beginning on or after January 1, 2007. A special rule allows plans to immediately permit contributions to continue for employees on leave due to military service. Plan amendments made after May 31, 2005, would be required to conform to the new rules. Additional IRS guidance will be needed if statutory provisions scheduled to sunset after 2010 are not repealed.

DISCUSSION Internal Revenue Code section 415 prescribes limits on the benefits from or contributions to a pension or profit-sharing plan. For 2005, the basic dollar ceiling on benefits is \$170,000 and the basic ceiling on contributions is \$42,000. These limits are affected by various factors, including the form of distribution and the level of a participant's compensation, and by other limits and qualification rules, including the separate limit on 401(k) plan deferrals. Plan documents must incorporate the limits and a plan must comply with the limits in operation to remain qualified.

Adjustments for Alternative Forms

The proposed regulations clarify that a plan must adjust the benefit ceiling to take into account benefits paid in a form other than a straight life annuity or a qualified joint-and-survivor annuity (QJSA). A plan must reduce the benefit ceiling to recognize automatic, fixed cost-of-living adjustments (COLAs) provided under the plan. The benefit ceiling must also be reduced to reflect any temporary Social Security supplement.

In one major reversal of IRS's previous informal position, a plan need not make an adjustment for any portion of a benefit paid in the form of a QJSA, even if part of the accrued benefit is paid in a form for which adjustment is necessary. Previous IRS guidance had indicated that if a participant withdrew a portion of benefits in one form, such as through a lump sum, then any remaining portion paid in the form of a QJSA would not have been eligible for an exemption from adjustment and thus would have been subject to a reduced limit. The proposed regulations also include rules designed to settle the complex adjustments required in the case of multiple annuity starting dates, such as when a retiree's benefit is boosted following a COLA-based increase in the section 415 ceiling.

Compensation-Based Limits

The IRS proposes two significant changes for the section 415 compensation-based limits:

- ❑ Compensation taken into account would be restricted to amounts earned during periods in which an individual was an active participant in the plan. This change could affect the limits for individuals who had received larger compensation amounts during pre-participation periods.
- ❑ The compensation limit (under section 401(a)(17)) — \$210,000 in 2005 — applies in the determination of section 415 limits. This reversal of previous informal IRS guidance would sharply curtail the benefits permissible for participants who delay retirement beyond normal retirement.

Amounts an employee received after severance from employment are not treated as compensation for purposes of applying the section 415 limits. Exceptions are made for certain payments paid within two-and-one-half months after severance, if the amounts would have been paid for services if the individual had remained employed or if the amounts are for bona fide sick, vacation, or other leave that could have been used if the individual had remained employed. Plan sponsors are permitted to immediately rely on this proposed rule.

Military Leave

An exception to the compensation-based limit is provided for individuals who are on leave due to military service, including National Guard and Reserve members, permitting them to continue to contribute to an employer's retirement plan. To encourage plan sponsors to adopt provisions that allow contributions during military leave, the IRS allows plans to rely on this exemption immediately.

Other Provisions

The proposed regulation, among many other changes, also would:

- ❑ make conforming changes to rules under tax code sections 401(a)(9), 401(k), 403(b), and 457, along with other corrections under section 457; and
- ❑ reflect statutory changes since 1981, such as: the phase-in of the dollar limitation over 10 years of participation; the exceptions to the compensation-based limit for governmental, multiemployer, and certain other collectively bargained plans; and the rules under which multiemployer plans are not aggregated with single-employer plans for purposes of applying the compensation-based limits to a single-employer plan.

ACTION

Plan sponsors should immediately review the proposed regulations in connection with the design and operation of their pension and profit-sharing plans. Comments to the IRS regarding the proposed rules should be submitted by July 25, 2005.

Any plan amendment made after May 31 should be reviewed for compliance with the new rules. Plan amendments may be necessary to bring existing plans into compliance by 2007. Administrative procedures should be reviewed and revised as necessary. For any instances where plan participants would encounter lower amounts under the proposed rules than the plan had been anticipating, communications with the participant may be advisable. Effects on the funding of plans and on coordination with excess benefit programs and other plans also should be reviewed.

For additional information about the IRS's proposed rules on limits on benefits and contributions under qualified retirement plans, please contact your Milliman consultant.

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