403(b) and 457(b) Plan Issues Under the New Proposed 415 Regulations

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The Internal Revenue Service recently issued proposed regulations under Code Section 415 dealing with maximum limits for annual additions to defined contribution plans and accruals under defined benefit plans. While these new proposed regulations broadly affect all qualified 401(a), 403(b), and 457(b) plans, this article will focus on several issues of particular concern to the plans of tax-exempt and governmental employers.

Treatment of "Termination Pay"

One of the more controversial provisions of the proposed 415 regulations, for governmental plans in particular but also for all 403(b) plans, is likely to be the treatment of various types of compensation paid to employees upon termination, often called "termination pay." Such termination pay can consist of different amounts, but typically includes unused sick or vacation leave, "comp" time, bonuses, and severance pay. Prior 415 regulations did not address the question of whether such termination pay was compensation for 415 purposes or whether it could be contributed to a plan at all.

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In practice, many plan sponsors allowed some such deferrals, if they were based on a pre-termination election and paid soon after termination, largely on the grounds that it was all W-2 compensation (which is one of the alternative definitions of compensation under the current 415 regulations), and no authority precluded it. Informally, however, representatives of the IRS have in the past expressed reservations about whether severance pay can be deferred, and whether any pay actually paid after the date of termination of employment could serve to support a plan contribution, whether elective or nonelective. Most recently, in the final 457(b) regulations, the IRS stated that, for purposes of that type of plan, only unused sick, vacation, and back pay, and not severance pay, could be deferred, and then only if it was payable before the severance of employment.

The proposed 415 regulations have liberalized the termination pay rules slightly, but not enough to catch up with what many plan sponsors have been doing or wish to do. Under the proposed 415 regulations, the general rule will be that amounts paid after severance of employment may not be treated as compensation for 415 purposes, with an exception only for the following types of payments, and only if made within 2½ months after severance of employment: (1) payments that, absent a severance from employment, would have been paid to the employee anyway, and are "regular compensation" for services, whether within or outside regular working hours, commissions, bonuses, or other similar compensation, and (2) 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. All other post-severance payments would not be compensation, such as severance pay, unfunded nonqualified deferred compensation, or 280G(b)(2) parachute payments.

In addition, at least for cash or deferred elections under 401(k) plans, the proposed regulations provide that termination pay cannot be deferred at all unless it meets the 415 definition of compensation. The provisions regarding 403(b) plans and 457(b) plans seem a little less clear, but the intent appears to be that only amounts treated as compensation for 415 purposes can be the subject of an elective contribution to a plan. The regulations are not clear on whether the rule is intended to extend to nonelective contributions, even though nonelective amounts would not normally be treated as compensation for 415 purposes.

The IRS does not explain why it makes a distinction between different types of compensation, or why severance pay, taxable as compensation for W-2 purposes, is excluded from the 2½ month rule. The 2½ month period is presumably borrowed from the rules for cafeteria plans and nonqualified deferred compensation plans. Whether the 2½ month rule applies to nonelective contributions is of particular concern to governmental plans, which are, subject to certain grandfather rules, not permitted to have cash or deferred arrangements, and to 403(b) plans, which are in some cases statutorily permitted to have additional nonelective contributions for up to an additional five years after termination of employment, as discussed below.

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Application of Section 415 to 403(b) Plans

The proposed 415 regulations address the operation of the 415 limits to 403(b) plans, dovetailing in some respects with the recently proposed 403(b) regulations. The 415 proposal regulations do not distinguish between 403(b)(1) annuity contracts, 403(b)(7) mutual fund custodial accounts, or 403(b)(9) church retirement income accounts in applying the 415 limits to 403(b) plans.

Excess 415 Amounts in a 403(b) Plan

The proposed 415 regulations reflect the provision in the proposed 403(b) regulations that the portion of the 403(b) contract which is an excess annual addition will fail to be a 403(b) contract, and will be a contract to which section 403(c) applies. Moreover, the portion of the 403(b) contract that is not an excess annual addition will not constitute a 403(b) contract, unless the issuer of the contract maintains a separate account for each portion. As some taxpayers have commented on with respect to the proposed 403(b) regulations, many providers do not perform such separate accounting, and would prefer to distribute the excess annual additions. Neither the proposed 403(b) nor proposed 415 regulations refer to this as a possibility. On the other hand, it is not clear that distributions will not suffice. The various 415 correction methods from the current 415 regulations have not been carried over to these proposed regulations, because, according to the preamble, they will be added instead to EPCRS. As a result, perhaps some relief may be provided when Rev. Proc. 2003-44 is next reissued.

Definition of "Includible Compensation" for 403(b) Plans

The proposed 415 regulations cross-reference the rule, post-EGTRRA, that compensation for 415 purposes under a 403(b) plan means "includible compensation" as determined under section 403(b)(3) and corresponding regulations. This includes the concept that a terminated participant can have compensation for purposes of the 415 limit for up to five years after termination of employment, though for nonelective contributions only. It is not clear, however, how the 2½ month rule for termination pay interacts with this rule, if at all. In addition, IRS representatives have recently begun informally to question whether the five-year period applies if the employee

terminates employment on account of death, or dies during the five-year period. More guidance is needed on these issues.

Special 403(b) Church Plan Rule

The proposed 415 regulations reflect the long-standing rule that in the case of an employee in a church plan, as defined in Code section 414(e), annual additions under a 403(b) contract will not be treated as exceeding the limitations of section 415(c) (the defined contribution limit) if annual additions for the church employee are not in excess of $10,000. There is a plan lifetime limit of $40,000 on the total amount of additions that can be made under this rule for a participant. The proposed regulations would clarify that only the amount in excess of the regular 415 limit each year that would be allowed by this rule will count towards the $40,000 lifetime limit.

Special Foreign Missionaries Rule

The proposed 415 regulations also reflect the long-standing rule that, in the case of an individual who is a church employee in any year performing services for the church outside the U.S., additions to a 403(b) contract will not be treated as exceeding the 415 (c) limits if annual additions do not exceed the greater of $3,000 or the employee's includible compensation with respect to services for the church outside the U.S. This effectively allows a $3,000 floor contribution limit for foreign missionaries.

Aggregation of 403(b) and 401(a) Plans

Importantly, the proposed 415 regulations carry over the rule that 403(b) plans and 401(a) plans are generally not aggregated for purposes of the 415 limits because the participant is deemed to own the 403(b) contract, with the exception of where the participant also controls the employer sponsoring the 401(a) plan or the 403(b) plan. This most commonly occurs in the case of a physician owning 50 percent or more of a separately incorporated practice sponsoring a 401(a) plan, while also being employed by a hospital and participating in the hospital's 403(b) plan. The proposed regulations would treat any excess as a result of that aggregation as an excess contribution to the 403(b) plan. Some taxpayers have commented that, in such a situation, it should be the 401(a) plan under the control of the participant that should bear any adverse consequence.

403(b) Plans Treated As Defined Contribution Plans

403(b) plans are treated as defined contribution plans under the proposed regulations. Presumably, this is because the proposed 403(b) regulations require that all 403(b) plans other than grandfathered 403(b)(9) church retirement income accounts be defined contribution plans. The preamble and proposed regulations further indicate, though, that grandfathered church 403(b)(9) defined benefit plans are subject to the limits of both section 415(b) and 415(c). However, the proposed regulations do not address how the 415(c) limits will apply to a defined benefit 403(b)(9) plan that does not maintain individual accounts.

Limitation Years for 403(b) Plans

The general rule for 403(b) plans is that the calendar year is the limitation year, provided that the participant may elect another 12-month period by attaching a statement to his or her income tax return. Also, if the participant is in control of an employer maintaining a plan, the limitation year is the employer's plan's limitation year.

Contribution Deadlines

For 415(c) purposes, employer contributions by tax-exempt and governmental employers to 403(b) or 401(a) plans must be made to the plan no later than the 15th day of the 10th month following the close of the employer's taxable year in which the limitation year ends. Employee (after-tax) contributions must be made no later than 30 days after the close of the limitation year. This does not change current ERISA rules, which may also be applicable, and the proposed 403(b) regulations would also add contribution deadline rules for that type of plan.

Governmental Plan Issues Not Addressed

The proposed 415 regulations do not address either qualified governmental excess benefit plans under section 415(m) or the purchase of past service credit under governmental defined benefit plans. The preamble to the regulations asks for comments on these provisions. However, the proposed 415 regulations do address questions of transfers from one qualified 401(a) plan to another, which, consistent with past regulations and rulings, are generally not considered annual additions.

Other Clarifications to the 457 Regulations

In addition to dealing with the 415 limitations, the proposed regulations also include modifications to the final 457(b) regulations to reflect the change in the definition of the term "dependent" under section 152 as a result of the Working Families Tax Relief Act of 2004.

Conclusion

Updating the 415 regulations, like the update of the 403(b) regulations last year, was a monumental task for the IRS. Many of the provisions generally reflect current law, and are not likely to engender much controversy. Clearly, though,

the IRS has chosen to introduce new guidance within the 415 regulations limiting the treatment of post-termination of employment pay as compensation for 415 purposes, and perhaps more importantly, limiting whether such termination pay can be contributed to plans at all. This is likely to be a fairly controversial position, particularly for governmental and 403(b) plans that tend to commonly permit such contributions on either an elective or nonelective basis.

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