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MEMORANDUM TO CLIENTS

July 11, 2005

Re: IRS Proposes Comprehensive Update of Section 415 Regulations

Culminating years of work, IRS and Treasury recently published comprehensive proposed regulations under the Code section 415 limitations on benefits and contributions for qualified plans. 70 Fed. Reg. 31,214 (May 31, 2005). Code section 415 imposes limits on benefits under qualified defined benefit plans and on contributions and other annual additions under qualified defined contribution plans. The defined contribution limitations also apply to annuity contracts under Code section 403(b) and to simplified employee pensions under Code section 408(k) as well as to certain individual medical accounts. The Code section 415 limits affect the amount of deduction a plan sponsor may take for contributions to a qualified plan (sec. 404), and the section 415 definition of "compensation" is used for determining plan limits (sec. 401(a)(17)) and a number of other purposes, including contributions to section 457 plans and IRAs.

The IRS last issued final comprehensive regulations under Code section 415 in 1981. Since that time, Congress has made numerous changes to Code section 415 – typically in response to revenue needs, with occasional efforts at simplification (e.g., repeal of the "combined plan" limit). The statutory changes have not been reflected in the regulations, but in various IRS notices, revenue rulings and other guidance.

The proposed regulations, with some modifications, reflect the previously published guidance. They also include a number of potentially significant changes – many of which announce new restrictions or add complexity – which we highlight below. The lengthy package also includes conforming changes to regulations under Sections 401(a)(9), 401(k), 403(b) and 457 of the Code.

In general, the proposed rules (when finalized) would be effective for limitation years beginning on and after 2007. There are limited exceptions where the rules may be relied upon earlier, such as for post-severance compensation and certain conforming regulations.

The IRS requested comments on the proposed regulations by July 25. A public hearing is scheduled for August 17.

Groom Law Group, Chartered
1701 Pennsylvania Ave., N.W. • Washington, D.C. 20006-5811 • 202-857-0620 • Fax 202-659-4503 • Email info@groom.com

A. Changes Primarily Affecting Defined Benefit Plans

Basic DB Limits – Timing – Current guidance provides that the benefit "to which a participant is entitled" during a limitation year may not exceed the lesser of (i) $160,000, adjusted for COLA increases in $5,000 increments (the "Dollar Limit") or (ii) the participant's average high consecutive 3-year compensation (the "Compensation Limit"). There has always been some ambiguity as to when these limits apply, for example, at distribution or as benefits accrue. The proposed guidance answers this question – the annual benefit "accrued by" or "payable to" a participant at any time may not exceed the lesser of the Dollar Limit or Compensation Limit and must, presumably, be taken into account in determining a plan's funding requirements. Another consequence of this timing rule is that even non-vested benefits (e.g., accrued but non-payable amounts) count towards the limits.

Plan Document Requirements – Current guidance permits plans to incorporate the complex 415(b) limits by reference. Also, certain elections (e.g., elections for non-calendar-year limitation years) may be implemented through employer resolutions (rather than through plan provisions). The proposed guidance states that plan provisions must preclude the possibility "that any annual benefit exceeding [the Dollar and Compensation Limits] will be accrued, distributed, or otherwise payable in any optional form of benefit." Elective rules must generally be set out in the plan (e.g., limitation year, years of service for calculating compensation), except where the regulations establish default rules and the employer wants to administer the plan using the default rules.

Annuity Contracts – Current guidance is ambiguous as to the application of the limits to benefits provided under annuity contracts. The proposed guidance clarifies that the limits apply to benefits under a plan, to an annuity contract making distributions on behalf of a plan, or through an annuity contract distributed under a plan (e.g., under a terminated plan).

Determining Average Compensation – Several of the most important changes and clarifications in the proposed guidance relate to the way plans determine a participant's average compensation for purposes of applying the Compensation Limit. As explained below in the DC plan section, the proposed guidance clearly excludes from 415 compensation (for purposes of applying the Compensation Limit) all post-termination compensation, with an exception for compensation that (i) is paid within 2-1/2 months after a participant separates from service, and (ii) would have been paid had the participant continued in employment or is paid pursuant to bona fide sick, vacation, and other leave (but only if the leave could have been used if employment had continued).

1. **Compensation Limited to Periods of Active Participation.** Current guidance provides that average high consecutive 3-year compensation is to be determined

over the period of an individual's employment within the sponsor's controlled group, including pre-participation years. The proposed guidance, on the other hand, takes into account only the period that an individual is an "active participant in the plan." Marty Pippins, the IRS's manager of Employee Plans Technical Guidance and Quality Assurance, describes this change as interpreting the calculation of average compensation "in the clearest statutory sense possible." Code section 415(b)(3) refers to compensation calculated over the calendar years "during which the participant both was an active participant in the plan and had the greatest aggregate compensation from the employer." This change would adversely affect, for example, small business owners who implement a pension plan in their final years of employment and take a salary cut in order to fund the plan.

2. **Calculating Short-Service Compensation.** Current guidance is ambiguous as to how compensation should be averaged for participants with fewer than three consecutive years of compensation. The proposed guidance clarifies that compensation is to be averaged over the longest period of consecutive service, including partial years. However, service for less than a year is always rounded to a full year.

3. **Section 401(a)(17) Limit.** Current guidance on the compensation limit provides that the $200,000 compensation limit (as adjusted) under 401(a)(17) applies only for two purposes: to limit compensation taken into account for accruals and to limit compensation taken into account for nondiscrimination testing. The proposed guidance extends section 401(a)(17) so that it also applies for purposes of applying the 415(b) Compensation Limit. Specifically, compensation used in determining a participant's average high consecutive 3-year compensation may not exceed the 401(a)(17) limit for any year. The IRS has not proposed changes to current 401(a)(17) guidance in order to implement this change.

Calculating Plan Accruals Subject to 415(b) Limits – Several important changes and clarifications relate to the calculation of plan accruals (which, in turn, must be compared to applicable 415(b) limits).

1. **Social Security Supplements.** Current guidance excludes from plan accruals subject to the limits the "value of benefits that are not directly related to retirement benefits." This guidance is ambiguous as to whether social security supplements can be excluded for 415(b) testing purposes. The proposed guidance clarifies that social security supplements may not be excluded from plan accruals subject to 415(b) limits, because they are directly related to retirement benefits.

2. **Payments to Survivors.** Under current guidance, survivor benefits paid under a qualified joint and survivor annuity (QJSA) are excluded from the 415(b) limits. Current guidance is ambiguous as to whether this exception applies if a participant elects

that a portion of his or her benefit be paid as a QJSA and another portion be paid in another form, such as a lump sum. The proposed guidance clarifies that the survivor portion of a QJSA is excluded from the 415(b) limits, even if a participant's entire accrued benefit is not paid as a QJSA.

3. **Benefits Attributable to Rollover Contributions.** Current guidance provides that the 415(b) limits do not apply to benefits attributable to rollover contributions, and that benefits attributable to rollover contributions are determined using reasonable actuarial factors. The proposed guidance provides that, for section 415 purposes, benefits attributable to rollover contributions (that are not maintained in a separate account) are determined under the rules and actuarial factors of section 411(c) (including use of an interest rate equal to 120% of the federal mid-term rate) – not the plan's factors. If the plan uses more favorable factors than the section 411(c) factors, only that portion of the benefit calculated using section 411(c) factors would be excluded from 415(b) testing. This position is likely to add complexity and discourage DB plans from accepting rollovers from unrelated plans.

4. **Transferred Benefits.** Current guidance includes some confusing rules for counting benefits when there is a transfer of assets and liabilities from one defined benefit plan to another. The proposed guidance includes much more detailed – but still confusing – guidance on transferred benefits. The basic idea underlying the proposed guidance is to avoid the double counting of transferred benefits. Where assets are transferred between plans that are maintained within the same controlled group and, thus, are aggregated for 415(b) testing purposes, the 415(b) limits are applied to the transferred benefits only in the transferee plan – the benefits are disregarded in applying the limits to the transferor plan. Where assets are transferred among plans of unrelated employers that are not aggregated in applying the 415(b) limits, the transferor plan applies the 415(b) limits to the present value of the amount of assets transferred on behalf of a participant from the transferor plan (other than surplus assets) as if a lump sum distribution were made. The transferee plan applies the 415(b) limits to the entire benefit, including the transferred benefit. The proposed guidance notes that this generally should not create a double-counting problem because "in most such cases … a participant whose benefits have been transferred would accrue no additional benefit under the transferor plan that would be required to be tested under that plan (in combination with the transferred benefits)."

Adjusting Benefits Not Paid in a Single Life Annuity (SLA) Form –

1. **Comparison to Plan's SLA.** Current guidance generally requires that the limits be compared to a participant's benefit payable in an SLA form. In the event benefits are payable in a non-SLA form, they must be converted to an SLA form. The non-SLA form is converted using (i) the plan's conversion assumptions and (ii) a 5%

interest rate (or the so-called GATT interest rate, for lump sums and other 417(e)(3) forms) and the so-called GATT mortality table. The larger SLA calculated under these two conversion methods is then compared to the applicable 415(b) limits. The proposed guidance adopts a similar conversion and comparison approach. However, for non-417(e)(3) forms (such as annuities), the requirement to convert using the plan's conversion assumptions is simply re-stated as the SLA actually payable under the plan, and the greater of that SLA or the SLA using the required conversion assumptions is compared to the 415(b) limits.

2. **Post-Commencement COLAs.** Over the years, plan sponsors have questioned whether a plan that provides post-commencement cost of living increases to annuity recipients (for example, a fixed percentage increase, or an increase based on cost of living adjustments under Code section 415(d)), must treat the annuity as a non-SLA form (requiring a conversion to an SLA, at commencement, for 415(b) purposes). Private Letter Ruling 200452039 indicates that an annuity with a cost of living feature would be treated as a non-SLA form for 415(b) purposes. The proposed guidance takes this same approach with respect to an annuity with a "fixed increase" (for example, of 2% per year), but does not specifically address treatment of an annuity with a post-commencement COLA tied to Code section 415(d) cost-of-living increases. The IRS may clarify this point in final regulations.

Mortality Adjustment for Benefits Paid After Age 65 or Before 62 – If benefits commence before a participant attains age 62, the Dollar Limit on benefits under section 415(b) is decreased. Current guidance supports applying a mortality adjustment to reflect the possibility that the participant could have died pre-age-62, but only if a benefit forfeiture would have occurred upon the participant's death.

If benefits commence after a participant attains age 65, the Dollar Limit on benefits under section 415(b) is increased. Current guidance supports applying a mortality adjustment to reflect the possibility that the participant could have died post-age-65, but only if a benefit forfeiture would have occurred upon the participant's death.

The proposed guidance generally would permit a plan to treat a benefit as not being subject to forfeiture (and, thus, avoid making any mortality adjustment), as long as the plan does not charge participants for the value of qualified preretirement survivor annuity (QPSA) coverage. However, to take advantage of this rule for post-65 adjustments, the plan also must treat a benefit commencing pre-62 as not being subject to forfeiture upon the participant's death.

Aggregating Plans – Current guidance requires the aggregation of plans maintained within the same controlled group. The proposed guidance refines this aggregation rule. Significantly, the proposed guidance requires that, in certain

circumstances, a plan must be aggregated with a plan maintained by a predecessor employer, even if the successor employer never assumes the plan of the predecessor employer. Code section 414(a)(2) has, for many years, given the Treasury Department the authority to define a predecessor employer in this way, but this is the first time in 30 years that Treasury has proposed using its authority. Under the proposed guidance, even if there is no plan assumption or transfer of plan assets and liabilities, an employer constitutes a "predecessor employer" for 415(b) purposes if, under the facts and circumstances, the current employer constitutes a continuation of all or a portion of the trade or business of the former employer (for example, where formation of the employer constitutes a mere technical change in the employment relationship, and continuity otherwise exists in the substance and administration of the former employer's business operation). It is not clear whether the IRS intends to apply this rule in common business circumstances such as where an entity sells to an unrelated third party, or spins off to its shareholders, a trade or business, and does not spin off any defined benefit plan assets and liabilities associated with the employees of the divested trade or business. A broad application of this "same desk"-type rule would require burdensome ongoing coordination and information-sharing among unrelated entities. On the other hand, the proposed rule may be targeted to transactions involving owners of closely held businesses. Clarification would be helpful.

Special $10,000 Minimum Limit – Current guidance provides that benefits up to $10,000 in a plan year may be payable to a participant under all aggregated defined benefit plans of the employer, without violating the section 415(b) limits (provided the employer has never maintained a defined contribution plan). The proposed guidance clarifies that the $10,000 minimum is applied to actual distributions made during a year, regardless of their actuarial value. For example, the minimum would not apply to a lump sum distribution of $11,000, even if the annuitized value of the payment would be less than $10,000 per year. Of course, under this rule, a participant with little compensation, but with the right to lump sum benefits in excess of $10,000 would often be ill-advised to elect the lump sum (with its 415(b)-required benefit cut). An example in the proposed guidance states that a "plan should not provide for a single-sum distribution in these circumstances." However, a plan that already contains such a single-sum distribution option may not eliminate it retroactively without violating anti-cutback (and, potentially, nondiscrimination) requirements.

Multiple Annuity Starting Dates – Current guidance does not explain how to determine "how much room" is left under a plan's 415(b) limit in the current year, when there have been distributions in prior years. For example, a plan may permit "phased retirement," or be aggregated with another plan where the timing of benefit payments differs, or have benefits increased to reflect post-retirement cost-of-living adjustments. The proposed guidance provides explicit methodologies for making these computations.

1. **Are There Multiple Annuity Starting Dates?** A preliminary issue is whether a new "annuity starting date" has occurred. Generally, the same definition of an annuity starting date that applies in the QJSA rules applies for 415(b) purposes. However, (i) if a retiree receives benefit payments which are later suspended during a period of reemployment, a new annuity starting date occurs when benefits recommence, and (ii) if a participant who is receiving benefit payments is credited with additional accruals after reaching normal retirement age, the participant will have a new annuity starting date for 415(b) purposes when his benefits are recalculated.

2. **General Calculation Rules.** The general rule is that, as of a determination date, the annual benefit subject to the 415(b) limit equals the sum of the annual benefit for: (i) any accrued benefit that has not yet commenced; (ii) any distribution beginning prior to the determination date, but during the current limitation year; (iii) any amounts remaining to be distributed with respect to a distribution beginning during a prior limitation year; and (iv) benefits attributable to prior distributions. The first three items are determined under general section 415(b) testing rules. However, complicated new rules apply in determining the accrued benefit attributable to prior distributions. Generally, this amount is determined by adjusting prior distributions to an actuarially equivalent straight life annuity commencing as of the current determination date. This value must reflect an actuarial increase to the present value of payments to reflect that the participant has survived during the interim period. These annual benefits are tested as of the determination date, adjusted for the participant's current age.

3. **What Is the Determination Date?** If there is an increase in benefits during a limitation year, the determination date is the last day of the period for which the increase accrues. If there is no increase in benefits during a limitation year, the determination date is the annuity starting date for the distribution that commences during the limitation year. If a stream of annuity payments is modified by a new distribution election, payments made prior to the change, plus the modified payments, must satisfy the 415(b) limit as of the original annuity starting date, using the interest rate and mortality table applicable as of such date, but adjusted to reflect any COLA increases taken into account under 415 between the original annuity starting date and the date of the modification.

4. **Cost-of-Living Increases.** In general, a COLA increase results in a new annuity starting date. Under a safe harbor, if a participant has received annuity payments that met the 415(b) limits before the COLA increase, the plan's benefit will meet the 415(b) limits after the COLA increase if the amounts payable for the limitation year and subsequent limitation years are no greater than the amounts that would otherwise be payable under the annuity without regard to the adjustment, multiplied by a fraction, the numerator of which is the 415(b) limit after the COLA adjustment (the Dollar Limit

adjusted for age at commencement), and the denominator of which is the 415(b) limit prior to the COLA adjustment.

B. Changes Primarily Affecting Defined Contribution Plans

Termination Pay – One of the more controversial provisions of the proposed 415 regulations is the treatment of various types of compensation paid to employees on or after termination, often called "termination pay." Such termination pay 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. In practice, many plan sponsors allowed some such deferrals, if based on a pre-termination election and paid soon after termination, largely on the grounds that it is all W-2 compensation and no authority precluded it. This practice was particularly common in the governmental plan sector where nondiscrimination rules do not apply. Informally, however, representatives of the Service have expressed reservations about whether severance pay can be deferred, and whether any pay actually paid after the date of termination of employment could support plan contributions, whether elective or nonelective. Most recently, in the final 457(b) regulations, the Service 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 liberalize the IRS position slightly, but not nearly enough to catch up with what many plan sponsors have been doing or wish to do. The proposed general rule is 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, or 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, such as severance pay, unfunded nonqualified deferred compensation, or 280G(b)(2) parachute payments, would not be considered compensation.

The Service does not explain the distinction between the different types of compensation, or why severance pay, taxable as compensation for W-2 purposes and normally subject to FICA, is excluded from the 2½ month rule. In this regard, although a 2½ month rule (originally contained in regulations for the deductibility of deferred compensation under section 404(a)) is increasingly being used as a "grace period" for

other purposes (e.g., sections 409A and 125), its relationship to severance of employment is unclear.

The IRS' proposed treatment of accrued leave as compensation also does not address whether the contribution based on such compensation must be elective or nonelective. If the contribution were elective, that would prohibit its deferral into governmental 401(a) plans (other than grandfathered 401(k) plans) and make it subject to the elective deferral limit for 403(b) plans, which may significantly limit the ability to defer those amounts at all.

The 2½ month limit on termination pay raises concerns with other common forms of ongoing payments as well. For example, unless an employee remains a common law employee while on a leave of absence or long-term disability, it is not clear that any compensation paid or deemed paid during the period of absence may be counted as compensation for 415 purposes. Code section 415(c) contains a limited exception for employees who meet the strict definition of disability under Code section 72(m), and only then if certain additional conditions are met. Of course, USERRA (and Code section 414(u)) provides relief for absences within its scope.

ESOPs – Value of Stock as Annual Addition – The proposed regulations provide that a plan may determine annual additions under an ESOP under which shares were acquired with an exempt loan either by reference to the principal and interest payments used to repay the exempt loan for the limitation year, or if the shares have decreased in value, by the fair market value of shares released from the suspense account. This limitation that fair market value of shares may be used only where the shares have decreased in value would be new, though it is the most common situation causing employers with ESOPs to adopt this rule.

"Restorative Payments" and Similar Transactions – The proposed regulations follow recent IRS guidance (e.g., Rev. Rul. 2002-45) that restorative payments to a participant's account associated with a "reasonable risk of liability for breach of fiduciary duty under Title 1 of ERISA" will not be annual additions subject to section 415.

Unfortunately, the proposed rules do not also address the situation where an investment manager pays amounts into a plan to make up for losses or charges imposed by the prior investment manager as a way of attracting the business (or making the switch "invisible" to employees). Similarly, they do not address the treatment of demutualization distributions or insurance company liquidations which also result in substantial payments, in the nature of earnings and not made by an employer, allocated to participant accounts.

Contribution Deadlines – To count as an "annual addition" for a particular limitation year, employer contributions must be credited to the participant's account for the limitation year, and the contributions must be made to the plan no later than 30 days after the end of the grace period for the taxable year in which the particular limitation year ends (which in most cases will be the time prescribed by law for filing the return for the taxable year in question, including extensions thereof). In the case of employer contributions by tax-exempt and governmental employers which do not file tax returns, plan contributions 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 and pre-tax contributions must be made no later than 30 days after the close of the limitation year. Of course, this does not change current ERISA rules for transmitting participant contributions.

Payments Under Other Plans as Compensation – Consistent with the current rules, the proposed regulations provide that amounts realized from the exercise of nonqualified options, or from restricted stock or other property held by an employee that becomes freely transferable or is no longer subject to a substantial risk of forfeiture, are not considered 415 compensation. Similarly, distributions from plans of deferred compensation (whether or not qualified) generally are also not considered compensation for section 415 purposes, regardless of whether such amounts are includible in the gross income of the employee when distributed. The regulations continue to provide an exception that, if the qualified plan so provides, any amounts received by an employee under other unfunded nonqualified plans (e.g., bonuses, incentive pay, etc.) may be considered compensation for 415 purposes in the year the amounts are actually received. However, this appears to be subject to the limitations on post-severance payments discussed above.

C. Special Rules For 403(b) Plans

The proposed 415 regulations address the operation of the section 415 limits to 403(b) plans, dovetailing in some respects with the recently proposed 403(b) regulations. The 415 proposal does 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.

Aggregation of 403(b) and 401(a) Plans – The proposed 415 regulations carry over the rule that 403(b) plans and 401(a) plans generally are not aggregated for purposes of the 415 limits because the participant is deemed to own the 403(b) contract. The exception is 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% 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.

403(b) Plans Tested as Defined Contribution Plans – 403(b) plans are treated as defined contribution plans under the proposed regulations. This is consistent with the proposed 403(b) regulations, which 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 that grandfathered church 403(b)(9) defined benefit plans are subject to the limits of both section 415(b) and 415(c), but do not address how the 415(c) limits will apply to a defined benefit 403(b)(9) plan which does not maintain individual accounts.

Limitation Years For 403(b) Plans – The regulations clarify that 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 limitation year of the employer's plan.

Excess 415 Amounts in 403(b) Plans – 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 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. Although neither the proposed 403(b) nor proposed 415 regulations refer to this as a possibility, 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, 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 reflect 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 regulations thereunder. That Code section includes a rule that a terminated participant can have compensation for purposes of the 415 limit for up to 5 years after termination of employment, solely for purposes of receiving nonelective contributions. (We note that IRS representatives recently have begun informally to question whether the 5-year period applies if the employee terminates employment on account of death, or dies during the 5-year period.) It is not clear how this rule interacts with the limits on termination pay described above, but presumably this statutory 403(b) exception would override the regulation.

Special 403(b) Church Plan $10,000/$40,000 Rule – The proposed 415 regulations reflect the longstanding 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 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 allowed by this rule will count towards the $40,000 lifetime limit.

Special Contribution Rule For Foreign Missionaries – The proposed 415 regulations also reflect the longstanding rule that, in the case of an individual who is a church employee in a 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.

D. Other Areas

Impact on DROPs – Many governmental plan sponsors have added "deferred retirement plan options" (DROPs) to their defined benefit and defined contribution plans. There are two basic types of DROP – DROPs that are part of a plan's overall defined benefit and separate DROP accounts that are treated as defined contribution plans under Code section 414(k).

Transfers to a DROP that is part of a defined benefit plan are aggregated with the other benefits provided under the plan and tested under the 415(b) limits. If the DROP is part of a plan aggregated with the transferor plan for 415 purposes (which is likely the case with respect to governmental plans), the benefit transferred to the DROP will not be subject to 415(b) testing in the transferee plan. If, however, the transferee plan is not aggregated with the transferor plan, the transferee plan must continue to take the transferred benefit into account for purposes of its 415(b) testing.

Transfers to 414(k)-style DROPs accounts in defined benefit plans are not treated as part of a defined benefit plan benefit. Transfers to 414(k)-style DROPs are tested under the 415 contribution limits applicable to defined contribution plans. Transfers between a money purchase plan and a DROP are not treated as annual additions subject to additional 415(c) testing. However, the proposed regulations do not address whether transfers from a defined benefit plan to a 414(k)-style DROP are included or excluded in the transferor plan's 415(b) testing. One interpretation is that if the DROP plan is aggregated with the transferor plan, the transferred benefit may be excluded from the transferor plan's 415(b) testing.

Governmental 415(m) Excess Plans and Purchases of Past Service Credit Under Code Section 414(n) Not Addressed – The proposed 415 regulations do not address either qualified governmental excess benefit plans under section 415(m), or the rules governing after-tax contributions made to purchase past service credit under governmental defined benefit plans (some of which also govern transfers from 403(b) and 457(b) plans to governmental defined benefit plans). The preamble to the regulations asks for comments on these provisions.

Clarifications to the 457 Regulations – 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. As a result, section 457(b) plans may continue to use the less restrictive pre-2004 definition of "dependent" for purposes of administering "emergency" distributions. A similar change has been included in the final 401(k) regulations and the proposed 403(b) regulations relating to hardship distributions.