

# MANUAL TRANSMITTAL

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Internal  
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Service

4.72.7

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## PURPOSE

This transmits complete reprint for IRM 4.72.7, Examination Guidelines for IRC 415(c).

## BACKGROUND

This IRM provides guidance on examining defined contribution plans subject to the limitations of IRC 415(c), as amended under Title VII of the Uruguay Round Agreements Act, Pub. Law 103-465 (GATT), the Small Business Job Protection Act of 1996, Pub. Law 104-188 (SBJPA), and the Tax Relief Act of 1997, Pub. Law 105-34 (TRA '97).

## NATURE OF CHANGES

This transmittal reissues and updates existing procedures in the new IRM format. IRM 4.72.7 replaces IRM 7.7.1 Chapter 7 using the same catalog number.

## EFFECT ON OTHER DOCUMENTS

This IRM replaces IRM 7.7.1 CH 7.

## INTENDED AUDIENCE

TEGE (Employee Plans)

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## 4.72.7

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4.72.7.1 (06-14-2002)

**Overview**

- (1) Guidance is provided on examining defined contribution plans subject to the limitations of IRC 415(c), as amended under Title VII of the Uruguay Round Agreements Act, Pub. Law 103-465 (GATT), the Small Business Job Protection Act of 1996, Pub. Law 104-188 (SBJPA), and the Taxpayer Relief Act of 1997, Pub. Law 105-34 (TRA '97). (Certain changes enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and affecting IRC 415(c) are provided as parentheticals.)

4.72.7.1.1 (06-14-2002)

**Technical Overview**

- (1) IRC 415 was added by the Employee Retirement Income Security Act of 1974 (ERISA), generally effective for plan years beginning after 1975. IRC 415 establishes limitations on the amount of contributions that may be allocated to and the amount of benefits that may accrue or be paid to any participant under a qualified plan. A qualified plan must satisfy IRC 415.
- (2) Limitations under IRC 415 (IRC 415 limitations) are applied to defined contribution (DC) plans by limiting the amount of employer and employee contributions that may be allocated to an individual's account(s) in all DC plans maintained by the employer in any one year to the lesser of--
- a. a specific dollar amount (DC dollar limitation), or
  - b. 25% of the participant's compensation (DC compensation limitation). See IRC 415(c).
- (3) IRC 415 limitations are applied to defined benefit (DB) plans by limiting the amount of benefit that can be accrued or paid to any plan participant in any plan year under all qualified DB plans ever maintained by the employer to the lesser of--
- a. a specific dollar amount (DB dollar limitation), or
  - b. 100% of the participant's high three-year average compensation (DB compensation limitation).

SBJPA provided that the DB compensation limitation does not apply to governmental plans for years beginning after December 31, 1994. (EGTRRA provides that the DB compensation limitation does not apply to multiemployer plans for years beginning after December 31, 2001) See IRC 415(b).

- (4) For limitation years beginning before January 1, 2000, where an employee is a participant in both a DC and DB plan of the same employer, an additional limitation is imposed on the individual's combined benefits under all of the plans maintained (or ever maintained) by the employer. **See IRC 415(e). IRC 415(e) is repealed for limitation years beginning on or after January 1, 2000. See Notice 99-44, 1999-2 C.B. 326, for guidance relating to the repeal of IRC 415(e).**
- a. For limitation years beginning before 2000, IRC 415(e) requires that, for each employee participating in both a DC plan and a DB plan of the employer, a separate fraction be computed based on the

individual's benefits under each plan type (DB and DC). The sum of these fractions may not exceed 1.0.

4.72.7.2 (06-14-2002)

### **Specific Plan Requirements**

- (1) Reg. 1.415-1(d) provides that the terms of a qualified plan must preclude the possibility that the limitations imposed by IRC 415 will be exceeded. Thus, the terms of a DB plan may not allow a participant to accrue a benefit in excess of the IRC 415(b) limits and the terms of a DC plan must limit allocations to the maximum allowed by IRC 415(c). For limitation years beginning before 2000, the terms of a DB plan and a DC plan must provide that where a participant participates in both a DC plan and a DB plan of the same employer, the combined limitation of IRC 415(e) will be satisfied.
- (2) The Tax Reform Act of 1986 (TRA '86) provided that the benefit and contribution limitations of IRC 415 could be incorporated in a plan by reference, but such an incorporation by reference must not violate the definitely determinable requirement of Reg. 1.401(a)-1(b)(1). Thus, the terms of the plan must preclude employer discretion, and any rules that allow optional methods of compliance must be stated in the plan.
  - a. For example, in a DC plan, the method for reallocating excess annual additions placed in a suspense account permitted under Reg. 1.415-6(b)(6) must be stated in the plan because there are three optional methods provided.
  - b. For limitation years beginning before January 1, 2000, where an employee participates in both a DB and a DC plan maintained by the same employer, the manner in which the employee's benefits will be adjusted to comply with the combined IRC 415(e) limitation is to be specified.
  - c. A plan that incorporates IRC 415 by reference must specify which definition of compensation is incorporated.

4.72.7.3 (06-14-2002)

### **Defined Contribution Plan Limitation**

- (1) Contributions and other additions with respect to a participant exceed the limitation of IRC 415(c) if, when expressed as an annual addition to the participant's account, such annual addition is greater than the lesser of \$30,000 (DC dollar limitation), or 25% of the participant's compensation (DC compensation limitation). IRC 415(d)(1) provides for adjustments to the DC dollar limitation for increases in the cost-of-living in accordance with regulations prescribed by the Secretary. (Amendments to IRC 415(c) under EGTRRA provide that, effective for limitation years beginning after December 31, 2001, the DC dollar limitation is \$40,000, and the DC compensation limitation is 100% of the participant's compensation.)

4.72.7.3.1 (06-14-2002)

### **Definitions and Concepts**

- (1) The following definitions and concepts are relevant to IRC 415(c).

4.72.7.3.1.1 (06-14-2002)

**Plan**

- (1) In applying the IRC 415 limitations to a participant, all qualified DC plans (whether or not terminated) ever maintained by the employer are treated as one DC plan, and all qualified DB plans (whether or not terminated) ever maintained by the employer are treated as one DB plan. See IRC 415(f). (EGTRRA added section 415(f)(3) to the Code which provides, effective for limitation years beginning after December 31, 2001, that a multiemployer plan is not aggregated with any other multiemployer plan for purposes of applying the limitations of section 415.)
- (2) IRC 415(k) provides that the term "DC plan" means a DC plan (within the meaning of IRC 414(i)) which is (a) a plan described in IRC 401(a) which includes a trust which is exempt from tax under IRC 501(a); (b) an annuity plan described in IRC 403(a) or an annuity contract described in IRC 403(b); or (c) a simplified employee pension (SEP) as described in IRC 408(k).
  - a. Included in this definition are money purchase plans, stock bonus plans, profit-sharing plans, target benefit plans, ESOPs, PAYSOPS, tax-sheltered annuities and contracts (as described in IRC 403(a) and (b)), and SEPs.
  - b. Although still included in the definition of DC plans under IRC 415(k), individual retirement accounts or annuities (IRAs) under 408(a) and (b) are not included as plans subject to IRC 415 for years after 1981. (Regulations have not been revised to reflect this). IRC 408A(a) provides that, except as provided in that section, Roth IRAs are treated in the same manner as individual retirement plans.
  - c. A hybrid plan, defined in IRC 414(k), is treated as a DC plan for IRC 415 purposes to the extent that plan benefits are based on the participants' separate accounts.
- (3) IRC 415(c) also takes into account amounts contributed under certain other types of qualified plans and nonqualified plans.
  - a. All employee contributions to a DB plan (whether mandatory or voluntary, and whether or not held in a separate account) are treated as a separate DC plan and are annual additions for IRC 415 purposes.
  - b. Included as annual additions for testing the dollar limitation (but not the percentage of compensation limitation) are amounts allocated to any individual medical account which is part of a pension or annuity plan described under IRC 415(l) and 401(h), and amounts contributed for key employees to separate accounts for post-retirement medical or life insurance benefits as provided under IRC 419A(d).

4.72.7.3.1.2 (06-14-2002)

**Employer**

- (1) IRC 414(b), (c), and (m) provide that for IRC 415 purposes, all employees of all corporations which are members of a controlled group of corporations, all employees of trades or businesses (whether or not incorporated) which are under common control, and all employees of the members of an affiliated service group are treated as employed by a single employer. IRC 415(h) provides that for purposes of applying IRC

414(b) and (c), the phrase "more than 50%" shall be substituted for the phrase "at least 80%" each place it appears in IRC 1563(a)(1).

**Example 1:** Company A maintains a money purchase pension plan and a profit sharing plan covering the same group of employees. For purposes of IRC 415(c), these two plans are treated as one plan, and the combined annual additions for each participant under both plans cannot exceed the IRC 415(c) limitation.

**Note:** Where a company was a member of a controlled group, or affiliated service group, which maintained a plan and the company subsequently leaves the group and establishes an unrelated new plan, the plan of the prior group is aggregated with the company's new plan for purposes of applying the IRC 415 limitations.

**Example 2:** Companies A, B, and C are members of a controlled group of corporations. Employees of all members of the controlled group are eligible to participate in a DC plan, Plan X. The Plan X plan year and limitation year are both the calendar year.

On 6/30/98, Company A ceases membership in the controlled group, and immediately establishes a nonrelated DC plan, Plan Y, and a DB plan, Plan Z, for its employees. Plans Y and Z both have a calendar year plan year and limitation year.

For the 1998 limitation year, contributions to both Plans X and Y would be aggregated for purposes of applying the IRC 415(c) limitations (Company A would be treated as maintaining both plans). Additionally, for purposes of applying the limitation of IRC 415(e) to the 1998 limitation year (and subsequent limitation years beginning before January 1, 2000) the DC fractions for those employees of Company A who have participated in Plans X and Y would include all contributions made on behalf of these employees under Plan X and under Plan Y.

4.72.7.3.1.3 (06-14-2002)

#### Examination Steps

- (1) Determine all DC and DB plans that are currently maintained by the employer (or have ever been maintained by the employer), along with their effective dates and earliest participation dates.
- (2) Determine whether the employer is a member of a controlled group of corporations, trades or businesses (whether or not incorporated) under common control, or an affiliated service group. Taking IRC 415(h) into account, determine whether the employer is treated with other members of these groups as a single employer for purposes of applying the IRC 415 limitations. If other members are to be taken into account, determine the same information for their plans as that determined for the employer.

4.72.7.3.2 (06-14-2002)

#### Limitation Year

- (1) The limitation on annual additions is applied to a "limitation year," which is the calendar year unless another consecutive 12-month period is elected by the employer. See Reg. 1.415-2(b).



4.72.7.3.2.1 (06-14-2002)

**Other Limitation  
Years**

- (1) To use any other consecutive 12-month period as the limitation year (other than the calendar year) or to change the limitation year the employer must elect one of the three methods discussed under the definition of limitation year --
  - a. Separate written resolution,
  - b. Adopt a plan with a limitation year other than a calendar year, or
  - c. Adopt a plan amendment changing the limitation year.
- (2) Once the limitation year is established, it may only be changed by one of the election methods described above.
- (3) If a change is made, the new limitation year must be a 12-consecutive-month period that begins on any day within the prior limitation year. This will create a short limitation period to which a prorated limitation will apply, if the plan is a DC plan. See Reg. 1.415-2(b)(4).
- (4) As a general rule, a group of employers which constitute a controlled group of corporations, commonly controlled trades or businesses, or affiliated service groups, within the meaning of IRC 414(b), (c), or (m), must all make the same election with respect to the limitation year. An employer that maintains more than one qualified plan must generally use the same limitation year for each plan.
  - a. However, the employer that maintains more than one plan, or the group of employers described above, may elect to use different limitation years as prescribed by Rev. Rul. 79-5, 1979-1 C.B. 165.
  - b. Rev. Rul. 79-5 is designed to provide relief in the case of two or more large plans of the same employer with accounting systems based on different plan years and few, if any, participants covered by more than one plan. The rules are complex and somewhat more restrictive than the general case.

4.72.7.3.2.2 (06-14-2002)

**Short Limitation  
Year**

- (1) If the employer changes the limitation year, a short limitation "year" or period is created because the new 12-consecutive-month period must begin on a day within the current limitation year. The short limitation period begins on the first day of the current limitation year and ends on the day before the first day of the new limitation year.
- (2) The limitation on annual additions is applied to the new limitation year in the normal manner. However, for the short limitation period, the DC dollar limitation in effect for the calendar year in which the short limitation period ends is multiplied by the following fraction (where the numerator includes fractional parts of a month): (number of months in short limitation period) divided by (12).
- (3) In applying the IRC 415(c) limitations to the short limitation period, the amount of compensation taken into account may only include compensation paid (or accrued where applicable) for this period. See Reg. 1.415-2(b)(4).

- (4) The short limitation period requirements apply only to changes in the limitation year.
- a. For a new participant, the dollar and percentage of compensation limitations in effect for their first limitation year, even if participation commences during the year, is always an entire year's dollar limitation and the applicable percentage of an entire limitation year's compensation, including compensation prior to participation (similarly for those who cease participation during a limitation year or for plans that begin or terminate during a limitation year).

**Example 3 – Short Limitation Year:** Under Plan X, a profit-sharing plan, the calendar year is the limitation year. On 6/30/98, the plan is amended to change the limitation year to a July 1 to June 30 year. Therefore, the new limitation year begins 7/1/98, and a short limitation period is created (1/1/98 to 6/30/98).

Since the short limitation period ends in 1998, a calendar year for which the dollar limitation is \$30,000, the dollar limitation for the short limitation period is:  $\$30,000 \times (6/12) = \$15,000$ .

Therefore, annual additions allocated in the short limitation period cannot exceed the lesser of (1) 25% of IRC 415 compensation earned (or accrued where applicable) during the short limitation period, or (2) \$15,000.

The new limitation year ends 6/30/99. The limitation on allocations for the new limitation year will be the lesser of (1) 25% of IRC 415 compensation for the new limitation year, or (2) \$30,000.

4.72.7.3.2.3 (06-14-2002)

#### Examination Steps

- (1) What is the limitation year for each plan? If the employer has elected to use a 12 consecutive month period other than the calendar year, was the election effected by one of the three methods discussed under the definition of limitation year (i.e., separate written resolution, adoption of a plan with a limitation year other than a calendar year, or adoption of a plan amendment changing the limitation year)?
- (2) If the limitation year has been changed and a short limitation period is created, has a prorated dollar limitation been used for the short limitation period? For purposes of determining the compensation limitation that applies for the short limitation period, has compensation earned (or accrued as applicable) during the short limitation period been used?

4.72.7.3.3 (06-14-2002)

#### Annual Additions

- (1) "Annual additions" means the sum, allocated to a participant's account for any limitation year, of:
- employer contributions;
  - employee contributions;
  - forfeitures;
  - allocations under a simplified employee pension;

- amounts allocated after March 31, 1984, to an individual medical account that is part of a pension or annuity plan maintained by the employer from which benefits described in IRC 401(h) are payable solely to such participant, the participant's spouse, or dependents; and
- amounts derived from contributions paid or accrued after December 31, 1985, in taxable years ending after such date that are attributable to post-retirement medical benefits allocated to the separate account of a key employee (as defined in IRC 419A(d)(3)) under a welfare benefit fund.

See IRC 415(c)(2).

- (2) Contributions do not fail to be annual additions merely because they are excess deferrals, excess contributions, or excess aggregate contributions, or merely because excess contributions are corrected through distribution or recharacterization. However, excess deferrals distributed in accordance with Reg. 1.402(g)-1(e)(2) or (3) are not annual additions.
- (3) For limitation years beginning before 1/1/87, annual additions consisted of employer contributions, forfeitures, and the lesser of the employee contributions in excess of 6% of compensation or one-half of the employee contributions for that year.
  - a. For plans maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before 3/1/86, the date of this change (in the determination of annual additions) is the earlier of---
    - the date on which the last collective bargaining agreement terminates (determined without regard to any extension thereof after 2/28/86), or
    - 9/30/91 (all employee contributions after this date) and 10/1/91 (the lesser amount before this date).

4.72.7.3.3.1 (06-14-2002)

#### **General Rules**

- (1) An amount is an annual addition if it is credited to a participant for a limitation year. An amount is credited if it is allocated to the account of a participant under the terms of a plan as of any date within that limitation year. See Reg. 1.415-6(b)(7)(i).
- (2) In general, employer contributions are not deemed credited to a participant's account for a particular limitation year unless they are actually made no later than 30 days after the IRC 404(a)(6) period for the tax year within which the limitation year ends. See Reg. 1.415-6(b)(7)(ii).
- (3) Forfeitures are annual additions for a limitation year if they are allocated to the account of a participant as of any date within the limitation year. See Reg. 1.415-6(b)(5).
- (4) There are 5 special cases where an employer contribution made to the plan in a limitation year is not considered an annual addition for that

limitation year but for the limitation year to which it relates. See Regs. 1.415-6(b)(2)(ii), (iii), (iv), (v), and (vi).

- a. Contributions made because of an erroneous forfeiture in a prior limitation year or an erroneous failure to allocate amounts in a prior limitation year.
  - b. Amounts paid to restore an employee's accrued benefit under IRC 411(a)(3)(D) or IRC 411(a)(7)(C) (i.e., the benefit is restored when withdrawn employee contributions are repaid).
  - c. Transfers are not annual additions in the transferee plan; however, they retain their identity as annual additions in the transferor plan.
  - d. Contributions to reduce an accumulated funding deficiency.
  - e. Contributions to repay a waived funding deficiency.
- (5) Employee contributions (voluntary and mandatory) are not deemed credited to a participant's account for a particular limitation year unless the contributions are actually made to the plan no later than 30 days after the end of such limitation year. See Reg. 1.415-6(b)(7).
- (6) Certain employee contributions are not treated as annual additions. See Reg. 1.415-6(b)(3).
- a. Rollover contributions;
  - b. Repayments of loans made to a participant from the plan;
  - c. Repayment of amounts paid out under IRC 411(a)(7)(B) (certain cash-out distributions), in accordance with IRC 411(a)(7)(C) and IRC 411(a)(3)(D); or
  - d. Direct transfers of employee contributions from one qualified plan to another.

4.72.7.3.3.2 (06-14-2002)

#### **Medical Benefit Accounts**

- (1) IRC 415(l) provides that contributions allocated to any individual medical account which is part of a pension or annuity plan must be treated as an annual addition to a DC plan for IRC 415(c) purposes. However, IRC 415(c)(1)(B) (the DC compensation limitation) does not apply to such amount. For this purpose, an individual medical benefit account is --
- a. Any separate account established for a participant under a pension or annuity plan, and
  - b. From which benefits described in IRC 401(h) are payable solely to such participant, their spouse, or their dependents.
- (2) Under IRC 401(h), where a pension or annuity plan provides for such medical benefits (which may include payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and dependents), such benefits must be subordinate to the retirement benefits provided by the plan.
- a. The requirement that benefits be subordinate to the plan's retirement benefit will not be satisfied if the actual contributions for medical benefits, when added to actual contributions for life insurance protection under the plan, exceed 25% of the total actual

contributions to the plan (other than contributions to fund past service credits) after the date on which the account is established.

- (3) IRC 401(h) also provides that a separate account must be established and maintained for such benefits, and the employer's contributions to such separate account must be reasonable and ascertainable.
  - a. All plan liabilities to provide such benefits must be satisfied before any part of the corpus or income of the account can be used for, or diverted to, any purpose other than providing such benefits.
  - b. Once all liabilities for such benefits are satisfied, the plan must provide that amounts remaining in the separate account are returned to the employer.
  - c. For benefits payable to each key employee (and his spouse and dependents), a separate account is established and maintained, and benefits payable for that key employee attributable to plan years beginning after 3/31/84, for which the employee is a key employee, must be paid from such separate account. For these purposes, a key employee is any employee, who at any time during the plan year or any preceding plan year during which contributions were made on their behalf, is or was a key employee as defined in IRC 416(i).
- (4) IRC 419A(d) provides that contributions for post-retirement medical benefits for key employees are treated as annual additions for IRC 415(c) purposes. However, the DC compensation limitation (IRC 415(c)(1)(B)) does not apply to such amounts.
  - a. Under IRC 419A(d), such amounts must be allocated to separate accounts, and benefits with respect to such key employees after retirement must be paid from these separate accounts. For these purposes a key employee is any employee who, at any time during the plan year or any preceding plan year, is or was a key employee as defined in IRC 416(i).

4.72.7.3.3.3 (06-14-2002)

**Employee Stock Ownership Plans (ESOPs)**

- (1) The rules for determining the amount of annual additions allocated to a participant's account under an ESOP are discussed in the ESOP examination guidelines.

4.72.7.3.3.4 (06-14-2002)

**Examination Steps**

- (1) Determine whether the limitations on annual additions are tested using the sum of the annual additions for all DC plans of the employer, including features of plans which are to be treated as DC plans for purposes of IRC 415 testing (such as employee contributions under contributory DB plans), and all DC plans of any other employer(s) which are to be treated along with the employer's plan(s) as a single plan.
- (2) Are contributions allocated to any individual medical account that is part of a pension or annuity plan treated as an annual addition to a DC plan

(although the IRC 415(c)(1)(B) compensation limitation will not apply to such amounts)? See IRC 415(l) and 401(h).

- (3) Are amounts attributable to medical benefits allocated to accounts for post-retirement medical or life insurance benefits provided to key employees, under IRC 419A(d), treated as an annual addition to a DC plan for IRC 415(c) purposes (although the IRC 415(c)(1)(B) compensation limitation will not apply to such amounts)?
- (4) Are all employees tested for satisfaction of the limitation on annual additions using the correct IRC 415 compensation? See 7.5 for definitions of compensation that may be used for IRC 415 purposes.

4.72.7.4 (06-14-2002)  
**IRC 415(c)**  
**Dollar Limitation**

- (1) The dollar limit on annual additions to a DC plan under IRC 415(c)(1)(A) (DC dollar limitation) is \$30,000. (IRC 415(c)(1)(A) was amended by EGTRRA to provide that the DC dollar limitation is \$40,000 for limitation years beginning after December 31, 2001.)
  - a. Each year the Service publishes the limitations applicable to qualified plans under IRC 415, adjusted for cost-of-living increases (COLAs) as provided for under IRC 415(d), and effective for the calendar year beginning January 1. The adjusted limitation is applicable with respect to limitation years ending with or within that calendar year.
  - b. Thus, where a plan has a limitation year that is not the calendar year, the limitation that applies to the plan's limitation year is the limitation in effect for the calendar year in which the plan's limitation year ends. See Reg. 1.415-5(a)(2).
- (2) Under GATT, for years beginning after 1994, the dollar limitation applicable to DC plans is adjusted separately under IRC 415(d), and any increase in the dollar limit which is not a multiple of \$5,000 is rounded to the next lowest multiple of \$5,000, but not below the amount in effect for years beginning in 1994. (Under EGTRRA, effective for years beginning after December 31, 2001, the base period taken into account for purposes of adjustments to the DC dollar limitation of IRC 415(c)(1)(A) is the calendar quarter beginning July 1, 2001, and cost-of-living increases in the DC dollar limitation under IRC 415(d) which are not a multiple of \$1,000 are rounded to the next lowest multiple of \$1,000.)

**Example 4:** Employer A has a plan year and a limitation year of July 1 to June 30. For the limitation year 7/1/97 to 6/30/98, the dollar limitation that applies for the IRC 415(c) dollar limitation on annual additions is the dollar limitation effective on 1/1/98.

4.72.7.4.1 (06-14-2002) <b>IRC 415(c) Annual Dollar Limitations</b>	ERISA Effective	1/1/76	\$25,000, adjust for COLAs \$26,825
		1/1/77	\$28,175
		1/1/78	\$30,050
		1/1/79	\$32,700
		1/1/80	\$36,875
		1/1/81	\$41,500
		1/1/82	\$45,475
	TEFRA	1/1/83	\$30,000
	Effective	1984 -2000	\$30,000
	Effective	1/1/2001	\$35,000

TEFRA reduction effective for Plans in existence on 7/1/82; Plans not in existence on 7/1/82, reduction applies to years ending after 7/1/82)

1983, 1984, 1985 COLA freeze imposed by TEFRA; 1986, 1987 freeze on COLAs extended by TRA '84;

TRA '86 amended DC dollar limitation to greater of \$30,000 or one-fourth of the DB dollar limitation of IRC 415(b)(1)(A), generally effective for years beginning after 12/31/86. [DB dollar limitation has to go above \$120,000 for DC dollar limitation to increase.]

For limitation years beginning after 1994, GATT eliminated the reference to the DB dollar limitation and provided that the DC dollar limitation would be adjusted separately, and any increase which is not a multiple of \$5,000 is rounded to the next lowest multiple of \$5,000, but not less than DC dollar limitation in effect for years beginning in 1994.

(For limitation years beginning after 2001, EGTRRA provided that the DC dollar limitation is \$40,000, adjusted each year under IRC 415(d)(1)(C), and any increase under IRC 415(d)(1)(C) which is not a multiple of \$1,000 is rounded to the next lowest multiple of \$1,000.)

4.72.7.5 (06-14-2002)  
**Compensation  
Limitation**

- (1) If 25% of a participant's compensation for a limitation year is less than the DC dollar limitation for that limitation year, then annual additions allocated to a participant's account for the limitation year cannot exceed such 25% of compensation (DC compensation limitation). (EGTRRA provides that, for limitation years beginning after December 31, 2001, the DC compensation limitation is 100% of compensation.)
- (2) Compensation is defined in Reg. 1.415-2(d), as amended by regulations published in the Federal Register on 9/19/91, and corrected by the Federal Register on 3/31/92.
  - a. The definition of compensation within the meaning of IRC 415(c)(3) was amended in conjunction with the final nondiscrimination regulations.

- b. The nondiscrimination regulations define plan year compensation as IRC 414(s) compensation, and IRC 414(s) references compensation as defined under IRC 415(c)(3) in defining compensation for IRC 414(s) purposes.
- (3) While the terms of a plan may provide a different definition of compensation for purposes of calculating the rate of employer contributions or the benefit accrual, a definition of compensation within the meaning of IRC 415(c)(3) must be used to determine whether the maximum permissible contributions or benefits have been exceeded. A plan that incorporates IRC 415 by reference must specify which definition of compensation is incorporated.

4.72.7.5.1 (06-14-2002)

**IRC 415(c)(3)  
Compensation**

- (1) Compensation within the meaning of IRC 415(c)(3) can be defined in three possible ways: the "traditional" IRC 415(c)(3) definition of compensation which includes all remuneration found in Reg. 1.415-2(d)(2) and excludes all other forms of remuneration, including exclusions listed in Reg. 1.415-2(d)(3); and two "alternative definitions" used for wage reporting purposes, as modified, which will be considered automatically to satisfy IRC 415(c)(3).

4.72.7.5.1.1 (06-14-2002)

**"Traditional"  
IRC 415(c)(3)  
Compensation**

- (1) For purposes of applying the IRC 415 limitations, the term compensation includes all of the following inclusions and does not include any other form of remuneration. The **inclusions** are:
  - a. Wages, salaries, fees for professional services, and other amounts received (without regard to whether or not an amount is paid in cash) for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan (as described in Reg. 1.62-2(c));
  - b. Earned income in the case of a self-employed individual (see IRC 401(c)(1) and (2) for definitions);
  - c. Amounts described in IRC 104(a)(3), 105(a), and 105(h), but only to the extent that these amounts are includible in the gross income of the employee;
  - d. Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are not deductible by the employee under IRC 217;
  - e. The value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includible in the gross income of the employee for the taxable year in which granted; and



- f. The amount includible in the gross income of an employee upon making the election described in IRC 83(b).
- (2) In determining amounts under (a) and (b) above, foreign earned income (as defined in IRC 911(b)), whether or not excludible from gross income under IRC 911, is included. Compensation under (a) above is to be determined without regard to the exclusions from gross income in IRC 931 and 933. See Reg. 1.415-2(d)(2).
- (3) Following are examples of remuneration **not** included in compensation.
- a. Contributions made by the employer to a plan of deferred compensation to the extent that, before the application of the IRC 415 limitations to that plan, the contributions are not includible in the gross income of the employee for the taxable year in which contributed;
  - b. Employer contributions made on behalf of an employee to a simplified employee pension described in IRC 408(k);
  - c. Any distributions from a plan of deferred compensation, regardless of whether such amounts are includible in the gross income of the employee when distributed, although amounts received from an unfunded nonqualified plan are permitted to be considered as compensation for IRC 415 purposes in the year the amounts are includible in the employee's gross income;
  - d. Amounts realized from the exercise of a non-qualified stock option or when restricted stock (or property) held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture (see IRC 83 and the regulations thereunder);
  - e. Amounts realized from the sale, exchange or other disposition of stock acquired under a qualified stock option; and
  - f. Other amounts which receive special tax benefits, such as premiums for group-term life insurance (but only to the extent that the premiums are not includible in the gross income of the employee), or contributions made by an employer (whether or not under a salary reduction agreement) towards the purchase of an annuity contract described in IRC 403(b) (whether or not the contributions are excludible from the gross income of the employee).
- (4) SBJPA amended IRC 415(c)(3) to provide that, for years beginning after December 31, 1997, compensation for IRC 415 purposes includes any elective deferral (as defined in section 402(g)(3)), and any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of IRC 125 or IRC 457.
- (5) For limitation years beginning after December 31, 2000, compensation for IRC 415 purposes also includes any elective amounts that are not includible in the gross income of the employee by reason of IRC 132(f)(4). See Notice 2001-37, 2001-25 I.R.B. 1340.
- (6) The regulations have not yet been updated to take the changes in (4) and (5) above into account.

- 4.72.7.5.1.1.1 (06-14-2002)  
**Safe Harbor  
Definition**
- (1) If a plan defines compensation for purposes of applying the IRC 415 limitations to include only those items specified in Reg. 1.415-2(d)(2)(i) and to exclude all those items listed in Reg. 1.415-2(d)(3), if applicable, the plan will automatically be considered to be using a definition of compensation which satisfies IRC 415(c)(3). Of course, statutory changes in the rules under IRC 415(c)(3) that are currently effective (but are not yet reflected in the regulations) must be taken into account for these purposes.
  - (2) Alternatively, for employees other than self-employed individuals treated as employees within the meaning of IRC 401(c)(1), a plan may define compensation using definitions in 7.5.1.2 and 7.5.1.3, used for wage reporting purposes, as modified herein, and the definition will be considered automatically to satisfy IRC 415(c)(3).
- 4.72.7.5.1.2 (06-14-2002)  
**IRC 3401(a)  
Wages**
- (1) Compensation is defined as wages within the meaning of IRC 3401(a) (for purposes of income tax withholding at the source) but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in IRC 3401(a)(2)).
- 4.72.7.5.1.3 (06-14-2002)  
**Information  
Required Under  
IRC 6041, 6051,  
and 6052**
- (1) Compensation is defined as wages within the meaning of IRC 3401(a) and all other payments of compensation to an employee by his/her employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under IRC 6041(d), 6051(a)(3), and 6052. See Regs. 1.6041-1(a), 1.6041-2(a)(1), 1.6052-1, and 1.6052-2, and also Reg. 31.6051-1(a)(1)(i)(C).
  - (2) This definition of compensation may be modified to exclude amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that at the time of the payment it is reasonable to believe that these amounts are deductible by the employee under IRC 217. Under this alternative definition, compensation must be determined without regard to any rules under IRC 3401(a) that limit the remuneration included in wages based on the nature or location of the employment or the services performed (such as the exception for agricultural labor in IRC 3401(a)(2)).
- 4.72.7.5.2 (06-14-2002)  
**General  
Comments**
- (1) The plan must provide a definition of compensation actually paid or includible in gross income in the year. For limitation years beginning before 1/1/92, the employer may elect to use compensation accrued for the limitation year, but all members of a controlled group of corporations or an affiliated service group (within the meaning of IRC 414(b), 414(c), or 414(m) as modified by 415(h)) must make the same election.
  - (2) If an employee is employed by two or more members of a controlled group of corporations, members of commonly controlled trades or

businesses or an affiliated service group, compensation for such employee includes compensation from all of the employers in the group, whether or not they maintain the plan.

**Example 5:** Employer Y maintains a profit sharing plan with an IRC 401(k) cash or deferred arrangement (CODA) for a group of employees. For the 1998 plan year, Employee Smith received a \$500 allocation under the profit sharing plan and elected to defer \$3,500 under the CODA, of which \$2,000 was matched by the employer. Smith's salary for the year (including the \$3,500 elective deferral) was \$35,000, and Smith received no other remuneration includible in compensation under Reg. 1.415-2(d).

For purposes of applying the IRC 415(c) limitations, compensation of \$35,000 would be used for Smith. Therefore, the compensation limitation applicable to Smith would be \$8,750 (25% of \$35,000). This is because elective 401(k) contributions are treated as compensation under any of the allowable definitions of compensation under IRC 415. Smith's total annual addition of \$6,000 (\$500 + \$3,500 + \$2,000) under the profit sharing plan did not exceed the dollar limitation (\$30,000) or the percentage of compensation limitation (\$8,750) applicable to Smith.

- (3) TRA '86 added IRC 401(a)(17) which imposes an annual compensation limit on the amount of compensation a qualified plan can take into account in determining allocations, in a DC plan, or benefit accruals, in the case of a DB plan.

**Note:** The percentage of compensation limitations of IRC 415(b) and IRC 415(c) are based upon the actual IRC 415(c)(3) compensation, without regard to the IRC 401(a)(17) compensation limit. However, the benefits and contributions to which the IRC 415 limits are applied cannot be based on compensation in excess of the IRC 401(a)(17) compensation limit. [Note that where a plan does not incorporate IRC 415 by reference and defines compensation for all purposes under the plan as compensation not in excess of the IRC 401(a)(17) compensation limit, the 25 percent of compensation limitation used under the plan will use compensation as defined under the plan, and the plan's compensation limitation will be more restrictive than the IRC 415(c) compensation limitation.]

4.72.7.5.3 (06-14-2002)

### Examination Steps

- (1) Is an IRC 415 definition of compensation used under the plan for purposes of determining whether the IRC 415 limitations have been exceeded?
- (2) Does the plan specify which definition is used for purposes of determining IRC 415(c)(3) compensation?
- (3) For limitation years beginning before 1998, are amounts which are deferred and not includible in gross income under IRC 125 plans, 401(k) plans, 403(b) plans, 408(k) plans, and 457 plans excluded from compensation for IRC 415 testing?

- (4) For limitation years beginning after December 31, 1997, does compensation for IRC 415 purposes include any elective deferral as defined in section 402(g)(3) (which includes elective deferrals under 401(k), 403(b), and 408(k) plans), and any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of IRC 125 or IRC 457?
- (5) For limitation years beginning after December 31, 2000, does compensation for IRC 415 purposes include any elective amounts that are not includible in the gross income of the employee by reason of IRC 132(f)(4)?
- (6) Is the employee's compensation from all members of a controlled group taken into account?

4.72.7.6 (06-14-2002)

**Permitted  
Remedies for  
Excess Annual  
Additions**

- (1) A DC plan must allocate contributions (and forfeitures where applicable) in accordance with a nondiscriminatory specified plan formula.
  - a. Forfeitures, if allocated, may be allocated using a separate formula. See Reg. 1.401-1(b)(1)(i) and Rev. Rul. 81-10.
  - b. A money purchase plan will have a contribution formula and an allocation formula that may or may not be the same.
- (2) If the plan provides for the allocation of forfeitures or allocations based on estimated compensation, it must contain the special provisions in Reg. 1.415-6(b)(6) which eliminate excesses resulting from these allocations. This is necessary to preclude excess annual additions because there is no way to limit forfeitures (i.e., people generally leave or die in an unpredictable manner).
- (3) If, as a result of the allocation of forfeitures, a reasonable error in estimating a participant's annual compensation, a reasonable error in determining the amount of elective deferrals (within the meaning of IRC 402(g)(3)) that may be made with respect to a participant within the IRC 415 limits, or under other limited facts and circumstances that the Commissioner finds justify the availability of the rules set forth in Reg. 1.415-6(b)(6), the annual additions under the terms of a plan for a particular participant would cause the IRC 415 limitations applicable to the participant for that limitation year to be exceeded, the excess amounts will not be deemed annual additions in that limitation year if they are treated in accordance with one of three methods provided in Reg. 1.415-6(b)(6). The plan must specify which of the three methods from this regulation section, described below, will be used to correct such excess annual additions.
  - a. The excess amounts in the participant's account are allocated and reallocated to other participants in the plan. If, following such allocation and reallocation, excess amounts remain after the IRC 415 limits have been met for all plan participants for the limitation year, then the amounts are held unallocated in a suspense account. In the

- next limitation year, all amounts in the suspense account must be allocated and reallocated to participants' accounts (subject to the IRC 415 limitations) before any employer contributions and employee contributions that would be annual additions may be made to the plan.
- b. The excess amounts in the participant's account are used to reduce employer contributions for that participant for the next limitation year (and succeeding limitation years, as necessary). If the participant is not covered by the plan at the end of the limitation year, the excess amounts are held in a suspense account and allocated and reallocated in the next limitation year in accordance with the rules in a. above. These amounts must be used to reduce employer contributions for all remaining participants. Excess amounts may not be distributed to participants or former participants.
  - c. Excess amounts are held in a suspense account. Beginning with the next limitation year, these amounts are allocated and reallocated to all the participants in accordance with the rules in a. above. The excess amounts must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for all plan participants. Excess amounts may not be distributed to participants or former participants.
- (4) Notwithstanding the rules in a., b., and c. above, Reg. 1.415-6(b)(6)(iv) provides that a plan may provide for the distribution of elective deferrals (within the meaning of IRC 402(g)(3)) or the return of employee contributions (whether voluntary or mandatory), to the extent the distribution or return would reduce the excess amounts in the participant's account.
- a. Where employee contributions or elective deferrals are distributed to reduce excess annual additions, the distribution is treated as a corrective disbursement rather than a distribution of accrued benefits, and is subject to the rules stated in Rev. Proc. 92-93, 1992-2 C.B. 505.
  - b. The return of mandatory employee contributions may result in discrimination in favor of employees who are highly compensated. If the plan does not provide for the return of gains attributable to returned employee contributions, such gains are considered an employee contribution (and an annual addition) for the limitation year in which the returned contributions were originally made.
  - c. Elective deferrals under IRC 401(k) and employer matching contributions under IRC 401(m) are annual additions for the limitation year in which they are allocated to participants' accounts. This is the case even where such amounts are excess deferrals, excess contributions, or excess aggregate contributions, including if such excesses are corrected by distribution or recharacterization. See, however, the exception for excess deferrals treated as provided in Reg. 1.415-6(b)(6)(iv).

**Note:** The correction of excess annual additions must be done according to the plan's terms, and in a timely manner (i.e., in the next limitation year(s)). All amounts allocated from a suspense account are an annual addition for the limitation year in which allocated, including any earnings. However, plans may provide that suspense accounts do not share in the earnings or losses of the trust.

4.72.7.6.1 (06-14-2002)

**Examination  
Steps**

- (1) Does the plan specify which method described in Reg. 1.415-6(b)(6) will be used when excess annual additions result from the allocation of forfeitures, a reasonable error in estimating a participant's annual compensation, or a reasonable error in determining the amount of elective deferrals (within the meaning of IRC 402(g)(3)) that may be made with respect to a participant subject to the limits of IRC 415?
- (2) Where excess annual additions are treated in accordance with one of the methods set forth in Reg. 1.415-6(b)(6), was the use of this regulation section justified, i.e., was the excess annual addition the result of the allocations of forfeitures, a reasonable error in estimating a participant's annual compensation, a reasonable error in determining the amount of elective deferrals (within the meaning of IRC 402(g)(3)) that could be made on behalf of the participant within the IRC 415 limits, or under other limited facts and circumstances did the Commissioner find the use of the rules in Reg. 1.415-6(b) was justified?
- (3) Where elective deferrals or employee contributions are returned to the extent necessary to reduce excess annual additions under Reg. 1.415-6(b)(6), does the plan provide for such returns?