

Part III – Administrative, Procedural and Miscellaneous

Certain Deduction Limits under the Pension Protection Act of 2006

Notice 2007-28

This notice provides guidance on certain of the changes made by the Pension Protection Act of 2006, Pub. L. 109-280 (PPA '06), to § 404 of the Internal Revenue Code (Code). Section 404 generally provides rules concerning the deduction for contributions to plans of deferred compensation. Some of the PPA '06 amendments to § 404 are effective for years beginning after December 31, 2005 (the 2006 changes) and others are effective for years beginning after December 31, 2007 (the 2008 changes). This notice provides guidance with respect to the 2006 changes and one related issue. Future guidance will be provided with respect to the 2008 changes.

Q-1. What changes to the rules of § 404 of the Code were made by PPA '06 for years beginning after December 31, 2005?

A-1. In general, PPA '06 amended § 404 to modify the deduction permitted for defined benefit pension plans under § 404(a)(1). PPA '06 also modified the combined limit on deductions for contributions to defined benefit plans and defined contribution plans with overlapping coverage as set forth in § 404(a)(7).

Q-2. To what years do the 2006 changes apply when the taxable year of the employer differs from the plan year of the plan?

A-2. The 2006 changes apply to taxable years of the employer beginning after December 31, 2005.

Under § 1.404(a)-14(c) of the Income Tax Regulations (regulations), if the plan year of the plan and the taxable year of the employer do not coincide, the deductible limit for the taxable year of the employer is permitted to be determined as any one of the following alternatives: (1) the deductible limit determined for the plan year beginning in the taxable year, (2) the deductible limit determined for the plan year ending in the taxable year, or (3) a weighted average of alternatives (1) and (2). A plan year used under any of these alternatives is referred to in this notice as an associated plan year.

The calculations of the deductible limit for a taxable year are based on the calculations with respect to an associated plan year or years and must reflect the

law in effect for the taxable year. For example, with respect to the 2006 calendar taxable year, any associated plan year (i.e., a plan year beginning in 2006 or plan year ending in 2006 that is used to determine the deductible limit for the 2006 taxable year) must reflect the 2006 changes. Thus, if the deductible limit is determined with respect to the plan year ending in 2006 (which begins in 2005), the calculation of the limit with respect to that plan year must reflect the use of an interest rate within the permissible corporate rate range (instead of an interest rate within the permissible 30-year Treasury rate range) (see Q&A-3 below) that was used for purposes of § 412, and must reflect the limitation based upon 150 percent of current liability (in place of the limitation based on 100 percent of current liability) under § 404(a)(1)(D). The funding method and other actuarial assumptions that were used for purposes of § 412 for that plan year must also be used for the calculations of the deductible limit.

As another example, in the case of a taxable year that is not the calendar year and that begins in 2005 and ends in 2006, and a plan year that is the calendar year, the deductible limit for any associated plan year must not reflect the 2006 changes. Thus, if the deductible limit for the taxable year beginning July 1, 2005, and ending June 30, 2006, is determined based upon the plan year beginning in the taxable year (the 2006 calendar plan year), the calculations of such limit must not reflect the limitation based on 150 percent of current liability (i.e., must be limited to 100 percent of unfunded current liability) and may use the 30-year Treasury rate in place of the corporate rate.

Q-3. What changes to § 404(a)(1) of the Code were made by PPA '06 for years beginning after December 31, 2005?

A-3. In general, PPA '06 amended § 404(a)(1) of the Code for years beginning after December 31, 2005, to replace the limitation of § 404(a)(1)(D) based upon unfunded current liability with a limitation based on 150 percent of current liability (140 percent in the case of a multiemployer plan). In addition, PPA '06 eliminated the § 404(a)(1)(F) option to use any interest rate within 90 percent to 110 percent of the weighted average of the rates of interest on 30-year Treasury securities during the 4-year period ending on the last day before the beginning of the plan year (the permissible 30-year Treasury rate range) for purposes of determining current liability in determining the maximum deduction under § 404(a)(1) rather than an interest rate within the 90 percent to 100 percent of the weighted average of the rates of interest on amounts invested conservatively in long-term investment grade corporate bonds (the permissible corporate rate range). The current liability is determined pursuant to existing guidance, including, for example, Notice 90-11, 1990-1 C.B. 319.

Q-4. When determining the deductible limit in accordance with the 2006 changes, is the deductible limit determined as of the valuation date for the plan year?

A-4. Yes, the deductible limit is determined as of the valuation date for the plan year and is adjusted for interest to the earlier of the end of the plan year or the end of the taxable year of the employer (the "relevant date"). See, for example, § 1.404(a)-14(f)(3) of the regulations.

Q-5. What does § 404(a)(1)(D)(ii) provide and is the adoption of a new plan treated as a plan amendment for purposes of § 404(a)(1)(D)(ii)?

A-5. Section 404(a)(1)(D)(ii) provides that, in the case of a plan which has 100 or fewer participants for the plan year, unfunded current liability shall not include the liability attributable to benefit increases for highly compensated employees (as defined in § 414(q), "HCEs") resulting from a plan amendment which is made or becomes effective, whichever is later, within the last two years. For purposes of § 404(a)(1)(D)(ii), the adoption of a new plan will not be treated as a plan amendment only if the employer did not maintain a defined benefit plan covering any HCE covered by the new plan during the past 2 years. Thus, for an employer with a taxable year that is the calendar year, if an HCE was covered by a defined benefit plan of the employer at any time during 2004 or 2005, a new plan established during the 2006 taxable year that covers that HCE would be considered a plan amendment for purposes of § 404(a)(1)(D)(ii).

Q-6. What changes to § 404(a)(7) were made by PPA '06 for years beginning after December 31, 2005?

A-6. In general, PPA '06 amended § 404(a)(7) of the Code for years beginning after December 31, 2005, to exclude multiemployer plans from consideration and to provide that the combined limit of § 404(a)(7) only applies in the case of employer contributions to one or more defined contribution plans to the extent that such contributions exceed 6 percent of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan.

Q-7. Is a plan that contains a qualified cash or deferred arrangement described in § 401(k) taken into account for purposes of the combined limit of § 404(a)(7)?

A-7. Yes, a plan that contains a qualified cash or deferred arrangement described in § 401(k) is taken into account for purposes of the combined limit of § 404(a)(7). However, pursuant to § 404(n), elective deferrals as defined in § 402(g)(3) are not taken into account. Thus, matching contributions and nonelective employer contributions are taken into account in applying the limits of § 404(a), including the combined limit of § 404(a)(7). If elective deferrals are the only contributions under a defined contribution plan, then the plan is not taken into account in applying the limits of § 404(a)(7).

Q-8. How does the combined limit of § 404(a)(7) apply when employer contributions to defined contribution plans (other than elective deferrals) exceed 6 percent of compensation of participants in those plans?

A-8. When employer contributions to defined contribution plans (other than elective deferrals) exceed 6 percent of compensation of participants in those plans, the amount of employer contributions to defined contribution plans to which the combined limit of § 404(a)(7) applies is equal to the amount of employer contributions for the plan year less 6 percent of compensation of participants in those plans. Thus, the combined limit of § 404(a)(7) (i.e., the greater of 25 percent of compensation, or the contributions to the defined benefit plan or plans to the extent such contributions do not exceed the amount necessary to satisfy the minimum funding standard for the defined benefit plans, treating a contribution that does not exceed the unfunded current liability as an amount necessary to satisfy the minimum funding standard for each defined benefit plan) applies to the total of employer contributions to defined benefit plans and employer contributions to defined contribution plans (other than elective deferrals), less 6 percent of compensation of participants in the defined contribution plans.

Q-9. How does the combined limit of § 404(a)(7) apply when employer contributions to defined contribution plans (other than elective deferrals) do not exceed 6 percent of compensation of participants in those plans?

A-9. When employer contributions to defined contribution plans (other than elective deferrals) do not exceed 6 percent of compensation of participants in those plans, the combined limit of § 404(a)(7) does not apply to any employer contributions to defined contribution plans. In such a case, the combined limit of § 404(a)(7) (i.e., the greater of 25 percent of compensation, or the contributions to the defined benefit plan or plans to the extent such contributions do not exceed the amount necessary to satisfy the minimum funding standard for the defined benefit plans, treating a contribution that does not exceed the unfunded current liability as an amount necessary to satisfy the minimum funding standard for each defined benefit plan) applies only to contributions to the defined benefit plans.

Drafting Information

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