

GRIST Report: Lower 2010 401(k), pension plan limits could challenge efforts to rebuild nest eggs

*By Heidi Rackley and Scott Tucker of Mercer's Washington Resource Group and Bill McClain of the Seattle office
Aug. 24, 2009*

In This Article

[Summary](#) | [Economic volatility could hit 2010 retirement plan limits](#) | [Will IRS allow retirement plan limits to drop?](#)
| [Other benefit plan limits unaffected](#)

Summary

Workers struggling to rebuild retirement savings hurt by the financial crisis may face another hurdle: The Code limits on qualified retirement plan contributions and benefits may go down in 2010. It's unclear whether IRS will interpret the law as requiring these limits to decrease if recent inflationary patterns continue into September. But plan sponsors may want to prepare for that possibility by assessing the implications for participant communications (including whether a 204(h) notice might be required for pension plans), financial planning tools, benefit calculation systems and discrimination testing (including ADP/ACP testing for 401(k) plans).

Economic volatility could hit 2010 retirement plan limits

Annual adjustments to qualified retirement plan limits affect elective deferrals, catch-up contributions, plan compensation, Code Section 415 annual additions and maximum defined benefit (DB) annuities, and compensation amounts for identifying highly compensated and key employees. Depending on inflation levels for August and September 2009, the statutory formula used for these adjustments could produce lower figures in 2010 relative to 2009. Should that occur, employers will be looking to IRS for guidance on whether plan limits will actually drop or remain unchanged. ([GRIST #20080291](#), April 17, 2009, provides a complete list of 2009 limits.)

For each limit, the cost-of-living adjustment is determined by multiplying a base amount by the ratio of the prior year's third-quarter CPI-U to the base-period CPI-U. The product is then subject to rounding rules. This basic formula applies when adjusting all limits, although the specific base amount, base period and rounding rules differ.

Example. The 2009 elective deferral limit of \$16,500 equals the base amount of \$15,000 multiplied by the ratio of the CPI-U for the third quarter of 2008 (657.833) to the base-period CPI-U for the third quarter of 2005 (590.6). This product ($\$15,000 \times 657.833 \div 590.6 = \$16,707$) is rounded down to the next lower multiple of \$500, resulting in \$16,500.

Example. The 2009 compensation limit of \$245,000 equals the base amount of \$200,000 multiplied by the ratio of the CPI-U for the third quarter of 2008 (657.833) to the base-period CPI-U for the third quarter of 2001 (533.3), rounded down to the next lower multiple of \$5,000 ($\$200,000 \times 657.833 \div 533.3 = \$246,703$, rounded down to \$245,000).

The CPI-U spiked in the third quarter of 2008 – significantly increasing 2009 qualified retirement plan limits – before falling back to prior-year levels in the fourth quarter. Since March 2009, each month's CPI-U has been below the corresponding 2008 value. For example, the July 2009 CPI-U of 215.351 is well below the July 2008 value of 219.964. If inflation remains at recent levels, the total CPI-U for the third quarter of 2009 is likely to be around 648. Under the statutory formula, this would produce a 2010 elective deferral limit of \$16,000 ($\$15,000 \times 648 \div 590.6 = \$16,458$, rounded down to \$16,000) and a compensation limit of \$240,000 ($\$200,000 \times 648 \div 533.3 = \$243,015$, rounded down to \$240,000).

Will IRS allow 2010 retirement plan limits to drop?

The Code is unclear what happens when the rounded value under the statutory formula goes down. One interpretation is that the prior year's limit remains in effect. Another possibility is that the limit goes down, but not below the base amount (\$15,000 for the elective deferral limit and \$200,000 for the compensation limit). If IRS adopts the second interpretation, this would be yet another setback for workers struggling to rebuild their retirement savings in the wake of the financial crisis.

Implications for ADP/ACP and general nondiscrimination tests. The second interpretation, if adopted, also could adversely affect ADP/ACP nondiscrimination testing for 401(k) plans, as some limits could go down while others remain unchanged under the statutory formula. For example, if the third-quarter CPI-U totals 649.65 – which would require only a modest uptick in inflation – the elective deferral limit would remain unchanged at \$16,500 ($\$15,000 \times 649.65 \div 590.6 = \$16,500$), but the compensation limit would drop to \$240,000 ($\$200,000 \times 649.65 \div 533.3 = \$243,634$, rounded down to \$240,000). For a participant earning at least \$245,000 and contributing the maximum allowed by law, the actual deferral percentage would increase from 6.73 percent ($\$16,500 \div \$245,000$) to 6.88 percent ($\$16,500 \div \$240,000$).

The effects of declining 2010 limits could even carry over to 2011 ADP/ACP testing for 401(k) plans and general nondiscrimination testing for other retirement plans. A drop in the Section 414(q)(1)(B) compensation threshold from \$110,000 in 2009 to \$105,000 in 2010 would affect the determination of highly compensated employees for 2011 nondiscrimination tests.

Drop in DB 415 limit would be administrative headache. A drop next year in the Section 415 maximum annual benefit under a DB pension plan should not affect participants who accrued the maximum amount in 2009. This is because Section 411(d)(6) prohibits plan amendments that reduce accrued benefits, and IRS treats the annual adjustment in the 415 limit as a plan amendment. But benefit calculation systems would have to be modified if the current \$195,000

maximum annuity is reduced to \$190,000 next year and applied to future benefit accruals (the 415 limit is adjusted if benefits start before age 62 or after age 65, or if benefits are paid in a form other than straight life annuity or qualified joint and survivor annuity). Should the limit drop to \$190,000 in 2010, DB plans would have to calculate 411(d)(6)-protected benefits at the end of the 2009 limitation year for participants starting benefits in 2010. Though few participants would likely be affected, the calculations could be quite burdensome.

Potential 204(h) notice requirement for pension plans. If IRS allows plan compensation limits and 415 limits on DC annual additions and DB maximum annuities to go down in 2010, some participants' 2010 benefits will be reduced. Because IRS views these annual limit adjustments as plan amendments, sponsors of DB and money purchase pension plans must consider whether these reductions are significant enough to trigger a 204(h) notice. ERISA Section 204(h) requires pension plans to provide 45 days' advance notice of a plan amendment to any participant whose future accruals are reasonably expected to be significantly reduced ([GRIST #20030114](#), May 7, 2003). For calendar-year plans, the notice deadline would be Nov. 17, 2009.

Action steps. IRS is expected to announce 2010 retirement plan limits on Oct. 15, 2009 – the date the Bureau of Labor Statistics releases the September CPI-U. While awaiting IRS guidance on the proper interpretation, plan sponsors should prepare for the possibility of lower 2010 retirement plan limits. Action steps include reviewing participant communications, financial planning tools and DB benefit calculation systems, including projected retirement benefit calculators. DB and money purchase pension plan sponsors should identify participants who could be affected by declining 415 and 401(a)(17) compensation limits and discuss with counsel whether a 204(h) notice should be provided if IRS allows the limits to go down.

Other benefit plan limits unaffected

This issue only affects qualified retirement plans, since other benefit plan limits are tied to the CPI-U (or its medical care component) for different periods. Limits on health saving accounts and high-deductible health plans are based on the CPI-U for the 12 months ending March 31; IRS has already announced 2010 values ([GRIST #20090111](#), May 14, 2009). Limits on the saver's credit, IRAs and Roth IRAs, Archer medical savings accounts, transportation fringe benefits, and adoption assistance programs are tied to the CPI-U for the 12 months ending Aug. 31, while qualified long-term care premium and per diem limits are tied to the medical care component of CPI-U for the month of August. These other CPI-U measures are showing year-over-year increases.

GRIST is prepared by Mercer's Washington Resource Group. For more information, contact the InfoServices team at +1 202 263 3950.

WRG only: #20090202