

**GRS RESEARCH MEMORANDUM**

RE: **Analysis of Proposed 415 Regulations Related to Governmental DB Plans**
FROM: Paul Zorn, Director of Governmental Research*
DATE: July 12, 2005

The following analysis focuses on key provisions of the proposed regulations that apply to governmental defined benefit plans and is not intended as a comprehensive review. The author is not an attorney and the statements made are not legal advice or opinion. Qualified legal counsel should be consulted to review the effect of these changes on individual plans.

On May 31, 2005, the IRS issued proposed regulations (REG-130241-04) relating to limits on qualified plans under Internal Revenue Code (Code) § 415. The proposed regulations consolidate statutory changes and IRS guidance issued since the regulations were last updated in 1981. They clarify and, in some cases, substantially modify the prior regulations. However, they do not address qualified governmental excess benefit arrangements under Code § 415(m) or purchases of service credit in governmental plans under Code § 415(n). In addition, they do not include guidance on the 2010 sunset provisions related to changes made by the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001. The regulations would generally become effective for plan limitation years beginning on or after January 1, 2007. Public comments to the IRS are due by July 25 and a public hearing is scheduled for August 17.

OVERVIEW OF THE LIMITS ON DB AND DC PLANS

Generally, Code § 415 limits the benefits that can be provided by defined benefit (DB) plans and the amounts that can be contributed to defined contribution (DC) plans. The 415 limits are qualification requirements under Code § 401(a). A plan that does not adhere to the limits risks disqualification by the IRS. In determining the limits, all DB plans of the same employer (whether or not terminated) are aggregated as one DB plan for testing purposes. Similarly, all DC plans of the same employer are aggregated as one DC plan.

Overview of the DB Limits

Code § 415(b) limits the employer-provided benefit that can be accrued by a DB plan participant to the lesser of a specific dollar limit (indexed to inflation), or 100 percent of the participant's average compensation for the highest three consecutive years. Although private-sector plans are subject to both limits, governmental plans are exempt from the limit related to average compensation for the highest three consecutive years.

- The proposed regulations incorporate the statutory increase in the dollar limit to \$160,000 as amended by EGTRRA in 2001, indexed to inflation (i.e., \$170,000 in 2005). The regulations also incorporate the statutory exception for governmental plans, multiemployer plans, and certain other collectively bargained plans from the limit related to average compensation for the three highest years.

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Overview of the DC Limits

Code § 415(c) limits the "annual additions" that can be made to a DC plan participant's account to the lesser of a specific dollar amount (indexed to inflation), or 100 percent of the participant's annual compensation. Annual additions include employer contributions, employee contributions, and forfeitures, but not rollovers from qualified plans. For the purpose of testing annual additions under § 415(c), a participant's compensation includes elective deferrals to 401(k), 403(b), 457(b), 125 "cafeteria" plans, and certain transportation fringe benefits under § 132(f)(4).

- The proposed regulations incorporate the statutory increase in the DC plan dollar limit under EGTRRA to \$40,000, indexed to inflation (i.e., \$42,000 in 2005), as well as changes to the definition of compensation that include the various elective deferrals and fringe benefits.
- The proposed regulations also modify the definition of compensation under 415(c)(3) to include compensation paid after separation from service to the extent it is paid within 2 ½ months after separation and would have been paid if the participant had continued in employment or paid as bona fide sick, vacation, or other leave.¹ This change in the definition of compensation is proposed to be effective for limitation years beginning after January 1, 2005, with conforming amendments made to regulations relating to 401(k), 403(b), and 457(b).
- The proposed regulations also incorporate statutory changes to the types of arrangements subject to the 415(c) limits. For example, contributions allocated to individual medical accounts which are part of a pension or annuity plan under Code § 401(h) are treated as contributions to a DC plan under § 415.²

Overview of the Compensation Limit

In addition to the 415 benefit and contribution limits, Code § 401(a)(17) limits the amount of compensation that may be taken into account when calculating contributions to or benefits provided from a qualified plan. The limit is expressed as a dollar amount, indexed to inflation (i.e., \$210,000 in 2005). For all private-sector plan participants and for public-sector plan participants hired after 1995, only compensation up to the 401(a)(17) dollar limit may be taken into account by the plan. However, special rules apply to some state and local plan participants hired before 1996.³

- The proposed regulations incorporate the statutory changes applying the 401(a)(17) limits to compensation that may be taken into account by the plan and clarify the interaction of the 415 and 401(a)(17) limits. Compensation in excess of the 401(a)(17) limits for any year is not permitted in determining the compensation for the highest three consecutive years.

¹ Proposed Regulation 1.415(c)-2(e)(3).

² Proposed Regulation 1.415(c)-1(a)(2)(ii)(C).

³ In 1993, the Omnibus Budget Reconciliation Act (OBRA '93) lowered the § 401(a)(17) maximum compensation limit from \$200,000 to \$150,000, indexed to inflation. Under the transition rules, governmental plans were allowed to grandfather compensation limits specified in the plan as of July 1, 1993, for employees hired before 1996 – provided the plan was amended to apply the OBRA '93 limits to employees hired in 1996 and after. In 2001, EGTRRA raised the § 401(a)(17) compensation limit to \$200,000.

415(b) DB LIMITS FOR STATE AND LOCAL GOVERNMENTAL PLANS

Generally under Code § 415(b), the unreduced dollar limit for DB plans (\$170,000 in 2005) applies to the employer-provided portion of the benefit, expressed as a straight-life annuity commencing between the ages of 62 and 65. For benefits provided in forms other than a straight-life annuity (e.g., lump sum distributions, period certain annuities, or benefits that are financed with after-tax employee contributions, etc.) the form of benefit must be adjusted to the actuarial equivalent of a straight life annuity for testing against the 415(b) limits (with certain exceptions).

Adjusting the Dollar Limit for Benefits Beginning Before Age 62 and After Age 65

General Rule. Code § 415(b)(2)(C) requires that the dollar limit be actuarially reduced for retirement before age 62, using prescribed interest rates and mortality tables, so that the age-adjusted dollar limit is actuarially equivalent to the unreduced dollar limit at age 62. For retirement after age 65, that dollar limit is actuarially increased using a similar methodology, if provided by the plan.

Mortality Adjustment. To the extent that the benefit is not forfeited upon a participant's death, no adjustment in the dollar limit is made to reflect the probability of the participant's death between the annuity starting date and attainment of age 62. Ignoring mortality would result in a higher dollar limit than would otherwise be the case.

- The proposed regulations would permit a plan to treat the benefit as not being forfeited if the plan "does not charge participants" for providing a qualified pre-retirement survivor annuity, but only if the plan applies this treatment for adjustments before age 62 and after age 65.⁴

Exception for Qualified Police and Firefighters. For participants in plans of state and local governments who are employees of police and fire departments (or former members of the U.S. Armed Forces) with at least 15 years of service, no actuarial adjustment to the dollar limit is made for retirement before age 62. Consequently, the 415(b) dollar limit for these participants is the same as the unreduced dollar limit regardless of retirement age.

- The proposed regulations would clarify the definition of qualified police and firefighters for 415(b) testing purposes as full-time employees of any police or fire department operated by a state or local government maintaining a DB plan to provide police protection, firefighting services, or emergency medical services.⁵
- **Comment:** This would make application of the limit easier to administer, since the exception would be based on employment with the police or fire department rather than on the job description. However, it could exclude employees in otherwise valid police, fire, or emergency medical service jobs who work outside of a police or fire department.

Adjusting the Form of Benefit

General Rule. Under § 415(b)(2)(A) and related regulations, if a DB plan pays a benefit in a form other than an employer-provided straight-life annuity, the benefit is actuarially adjusted to a straight life annuity beginning at the same age for testing under 415(b). Benefits requiring adjustment include those paid as a lump sum, a period certain, or for which employees make after-tax contributions, etc.

⁴ Proposed Regulations 1.415(b)-1(d)(2)(ii).

⁵ Proposed Regulations 1.415(b)-1(d)(3).

Benefits Not Taken Into Account. Qualified joint and survivor annuities (QJSAs) are not taken into account when making this adjustment. In addition, other “ancillary benefits” not directly related to retirement benefits are also not taken into account, such as: pre-retirement disability benefits that do not exceed the qualified disability benefit, pre-retirement incidental death benefits (including a qualified pre-retirement survivor annuity) and post-retirement medical benefits.

- The proposed regulations modify the rule for QJSAs so that if benefits are paid partly in the form of a QJSA and partly in another form (e.g., a lump sum distribution), the portion paid as the survivor benefit is not taken into account in determining the annual benefit.⁶ This would apply the QJSA exception to the portion of the benefit paid in the form of a QJSA.
- The proposed regulations also clarify that Social Security supplements are included in determining the annual benefit. Although the supplements might otherwise be thought of as ancillary benefits, the IRS considers them directly related to retirement income.⁷

Adjusting the Form of Benefit for Mandatory, After-Tax Member Contributions. Benefits derived from mandatory, after-tax member contributions are subtracted from the benefits tested against the 415(b) limits.

- The proposed regulations clarify that the value of mandatory, after-tax employee contributions subtracted from the benefit for 415(b) testing purposes is calculated using interest rates and other factors specified in Code § 411(c) and related regulations, regardless of whether § 411 applies to the plan.⁸ Generally, this involves accruing interest on the contributions using prescribed rates and then converting the accumulated value of the contributions (with interest) to an annuity using the interest rate and mortality table referenced in Code § 417(e)(3) (i.e., the 30-year Treasury Securities Rate and unisex 1994 Group Annuity Reserving Table projected to 2002).
- The regulations also clarify that picked-up contributions are to be treated as employer contributions to a DB plan for 415 testing purposes.⁹ Voluntary employee contributions are to be treated as contributions to a DC plan.¹⁰
- Moreover, in determining the member-financed portion of the retirement benefit, member repayments of withdrawn contributions would be excluded, even if paid after-tax (i.e., as part of the investment in contract).¹¹
- **Comment:** The exclusion of repaid contributions from the member-financed portion of the benefit seems inconsistent; since they would have been counted if the member had never withdrawn them (assuming the employer had not picked-up the redeposit.)

Adjusting the Form of Benefit for Rollovers. Rollovers from qualified plans are also excluded from the benefit tested against the 415(b) limits. This would occur if a distribution from a DC plan or an IRA is rolled into a DB plan to provide an annuity.

- The proposed regulations clarify that the annual benefit attributable to the rollover that is subtracted from the benefit for 415 testing purposes is calculated using interest rates and other

⁶ Proposed Regulations 1.415(b)-1(c)(4)(ii)(B).

⁷ Proposed Regulations 1.415(b)-1(c)(4)(ii)(A).

⁸ Proposed Regulations 1.415(b)-1(b)(2)(iii).

⁹ Proposed Regulations 1.415(b)-1(b)(2)(ii).

¹⁰ Proposed Regulations 1.415(b)-1(b)(2)(iv).

¹¹ Proposed Regulations 1.415(b)-1(b)(2)(ii)(D).

factors specified in Code § 411(c) regardless of the assumptions used to compute the annuity distribution under the plan.¹² As a result, if the plan uses more favorable factors to determine the value of the annuity resulting from the rollover, the benefit tested under 415(b) would include the additional value of the annuity benefit over the amount that would have been payable using the interest rate and mortality assumptions under 411(c).

- The regulations also clarify that rollovers to a separate account under Code § 414(k) do not give rise to an additional DB benefit, since the separate account is treated as a DC plan. Moreover, rollover contributions to a DC plan are excluded from the definition of annual additions.¹³

Adjusting the Form of Benefit for Transfers. The proposed regulations modify existing rules for determining the value of transferred benefits to be excluded from the annual benefit tested under the 415 limits. Under the proposed regulations, treatment of the transferred amounts would depend on whether or not the transfer is made between plans that are required to be aggregated for 415(b) testing purposes under Code § 415(f). Plans that must be aggregated for testing purposes include all DB plans of the same employer (whether or not terminated). Plans that are not aggregated for testing purposes include DB plans maintained by different employers.

- **For transfers between aggregated plans** - the transferred benefits are included in determining the annual benefit under the plan receiving the transfer (“transferee plan”) and are disregarded in determining the annual benefit under the plan making the transfer (“transferor plan”).¹⁴ Consequently, the annual benefits tested under 415(b) are the actual benefits provided under each plan after the transfer.
- **For transfers between plans that are not aggregated** - the assets associated with the transferred liabilities (other than surplus assets) are treated by the plan making the transfer as a single-sum distribution and, presumably, tested under the 415(b) limit. However, no corresponding adjustment is made to the annual benefit under the plan receiving the transfer. The actual benefit provided by the plan receiving the transfer is used to determine the annual benefit to be tested under the 415(b) limit.¹⁵
- **Comment:** The proposed regulations do not address the difficulties faced by some public-sector employers in administering the aggregation rules of § 415. Some governmental units have employees who participate in more than one plan, and where the employer and the plans may not know what the others are doing. For example, a city employee may participate in a statewide plan for political subdivisions, and in a supplemental plan maintained by the city.

Adjusting the Form of Benefit for Automatic Fixed COLAs. In a private letter ruling (PLR 200452039) issued last September, the IRS stated that the requesting governmental plan was required to include the plan’s fixed automatic COLA in the value of the straight life annuity to be tested against the 415(b) limits. (Note: Private letter rulings are written specifically for the requesting entity.) Incorporating the automatic fixed COLA into the form of benefit increases the benefit to be tested under 415(b). Benefits in excess of the 415(b) limit can be paid from a qualified governmental excess benefit arrangement as provided in Code § 415(m).

- Although the proposed regulations do not refer to the private letter ruling, they do include an example illustrating the treatment of an automatic fixed COLA. As provided in the example, the

¹² Proposed Regulations 1.415(b)-1(b)(2)(v).

¹³ Proposed Regulations 1.415(c)-1(b)(3)(i).

¹⁴ Proposed Regulations 1.415(b)-1(b)(3)(i)(A).

¹⁵ Proposed Regulations 1.415(b)-1(b)(3)(i)(B).

level annual benefit for testing purposes under 415(b) is actuarially equivalent to the benefit payment stream including the fixed COLA, and actuarial equivalence is determined using a 5% interest rate and the specified IRS mortality table.¹⁶

- **Comment:** The proposed regulations appear to forego the simpler approach of annually testing the current actual benefit (including cumulative COLAs) against the current 415 dollar limit (based on original retirement age).

ADJUSTING THE DOLLAR LIMIT FOR INFLATION

Code § 415(d) requires the IRS to annually adjust the \$160,000 DB dollar limit for inflation, based on changes in the Consumer Price Index (CPI), rounded to the next lowest multiple of \$5,000. A similar adjustment is made to the \$40,000 DC dollar limit, rounded to the next lowest multiple of \$1,000. In conjunction with this adjustment, a plan may increase benefits otherwise limited by 415(b), but only if the plan explicitly permits such increases and does so in conformance with the regulations.

- The proposed regulations incorporate the statutory changes to the 415(d) rounding amounts for DB and DC plans. Under EGTRRA, the rounding amount for the DB dollar limit fell from \$10,000 to \$5,000, and the rounding amount for the DC dollar limit fell from \$5,000 to \$1,000.
- The proposed regulations clarify that a DB plan may apply the increased dollar limit to participants who have already begun receiving plan benefits, but only to the extent the benefits have not been paid. For example, a plan cannot apply the adjusted dollar limit to a participant who previously received the entire benefit as a lump sum distribution. However, a plan can apply the adjusted dollar limit to a retired participant who accrues additional benefits under the plan (e.g., through a plan amendment or COLA) that would otherwise have been limited by the 415 dollar limit.¹⁷ To do so, the plan must apply either the “safe harbor” rules or the rules related to “multiple annuity starting dates.” Under the safe harbor rules, the benefit may be increased by the ratio of the new 415 dollar limit (as adjusted for age at benefit commencement) to the prior 415 limit (similarly adjusted) – but may not exceed the amount that would otherwise be payable under the plan.¹⁸
- Application of the safe harbor method is contingent upon the participant having received one or more distributions that satisfy the requirements of 415(b) before the date the increase in the 415(b) limits becomes effective.¹⁹ For plans with automatic COLAs, this would appear to require that the value of the COLA be included in the straight life annuity originally tested against the 415(b) limits. However, no mention of this is made in the examples that illustrate the safe harbor.²⁰
- If the plan does not use the safe harbor and the plan adjusts benefits to reflect increases in the dollar limits, the plan must treat the benefits as having multiple annuity starting dates and test accordingly as described in the next section.

¹⁶ Proposed Regulations 1.415(b)-1(c)(5), Example 6.

¹⁷ Proposed Regulations 1.415(d)-1(a)(4)(iii).

¹⁸ Proposed Regulations 1.415(d)-1(a)(5).

¹⁹ Proposed Regulations 1.415(d)-1(a)(5)(i).

²⁰ Proposed Regulations 1.415(d)-1(a)(6), Examples 1 and 2.

MULTIPLE ANNUITY STARTING DATES

The proposed regulations would establish an entirely new and extremely complicated set of calculations for annuities with “multiple annuity starting dates.”²¹ These rules would apply in situations where a participant has received one or more distributions in limitation years: (i) prior to an increase in the accrued benefit during the current limitation year, or (ii) prior to the annuity starting date for a distribution that begins during the current limitation year. Among other situations, this might occur as a result of:

- Post-retirement benefit increases due to an additional benefit accrual obtained as a result of a return to service,
- Post-retirement COLAs pursuant to an adjustment in the 415(b) dollar limit, or
- Qualified domestic relations orders (or similar orders) where the alternate payee’s benefit commences before the member’s. When the member retires, it appears the combined benefit would be tested under the rules for multiple annuity starting dates.

In the case of multiple annuity starting dates, the annual benefit subject to the 415(b) limits is calculated as the sum of the annual straight life equivalent annuity attributable to:

- Prior distributions,
- Distributions within the current limitation year and on or before the current determination date,
- Distributions made after the determination date under the distributions that have already begun, and
- Distributions that have not yet begun.

Comment: The rules related to multiple annuity starting dates would be difficult (and expensive) to implement. Moreover, they would require information that may not be available. For example, section 1.415(b)-2(b)(2)(i) refers to calculating the “actuarial equivalent of that prior distribution, computed using the interest rate and mortality table specified under the plan that provides for the current distribution or current accrual that are used to determine offsets, if any, for prior distributions...” However, many plans will not have specified assumptions that apply in determining offsets for prior distributions.

CONCLUSION

Overall, the proposed regulations present a complicated framework for testing benefits provided by DB plans and annual additions made to DC plans. Given that the 415 limits are required for plan qualification, it is important for plan administrators to understand how the proposed regulations will affect their individual plans. It would also be useful to advise the IRS regarding ways to improve the regulations.

²¹ Proposed Regulations 1.415(b)-2.