

**SUMMARY OF TREASURY/IRS RESPONSES TO PUBLIC FUND CONCERNS
IN RECENTLY ISSUE FINAL IRC §415 REGULATIONS**

Calculation of Straight Life Annuity Where Plan Provides COLAs

IRC §415(b) generally requires a benefit paid in a form other than a straight life annuity to be actuarially converted to a straight life annuity for the purposes of testing the benefit against the 415(b) defined benefit limitations.

The proposed regulations would have required plans to actuarially factor future COLA increases into the calculation of the straight life annuity to be tested against the 415(b) limit at retirement. This approach, if adopted could have caused the pension benefits of some governmental plan retirees to be cut back at retirement even though their benefits (disregarding the actuarial value of future COLA increases) would have been under the 415(b) dollar limit at retirement and their benefits as subsequently increased by COLAs would never have violated the 415 dollar limit as it increases over time.

In the final regulations, Treas. Reg. §1.415(b)-1(c)(5) provides that, when determining the straight life annuity, no adjustment is required to take into “an automatic benefit increase feature”, provided certain conditions are met:

First, IRC §417(e)(3) must **not** apply to the form in which the benefit is paid. It may not be entirely clear what is meant by this condition, inasmuch as IRC §417(e) has to do with restrictions on cash-outs and §417(e)(3) has to do with determining present values.

It does appear from the Preamble to the final regulations (72 Fed. Reg. 16882) that the mere fact that IRC §417 does not otherwise apply to public sector plans (because §417 is an elaboration on IRC §401(a)(11) from which governmental plans are exempt) does not mean that any form of benefit provided by a governmental plan is not subject to IRC §417(e)(3) for the purposes of the automatic benefit increase exception. So it cannot be assumed that any form of benefit provided by a governmental plan would automatically satisfy this condition.

As to what benefits may or may not satisfy this condition, Example 2 to Treas Reg §1.415(b)-1(c)(6) says IRC §417(e)(3) does not apply to a 10 year certain and Example 5 in the same provision says IRC §417(e)(3) does not apply to a joint and survivor benefit with a 10 year certain feature. Example 7 says that IRC §417(e)(3) does not apply to a single life annuity with a fixed 2% annual increase. On the other hand, Example 4 indicates IRC §417(e)(3) would apply to a single sum distribution in lieu of an annuity. I have been pointed to Treas. Reg. §1.417(e)-1(d)(6) which would appear to exempt from §417(e) any distribution paid in the form of an annual benefit that does not decrease during the life of the participant or decreases during the life of the participant merely because of the death of a survivor annuitant or the cessation or reduction of Social Security supplements or qualified disability benefits. Plan counsel will have to consider whether the forms of benefits provided by their plan would be considered subject to IRC §417(e)(3) for this purpose.

Second, the “automatic benefit increase feature” must provide for automatic, periodic increases in the retiree’s annuity benefit. Such increases can occur, for example, “according to a specified percentage or objective index or for the purpose of sharing in investment returns on plan assets.” Presumably, common COLA provisions which provide for fixed increases, increases keyed to increases in the CPI, and/or increases keyed to investment returns would satisfy this condition. It is not clear, however, whether there might be other types of COLA provisions which would satisfy the general definitely determinable benefit rule of IRC §401(a) but would not pass this condition.

Third, the straight life benefit (without regard to the automatic benefit increase feature) would not exceed the 415(b) limit at the annuity starting date.

Fourth, the plan provides that in no event will the amount paid to the retiree in any succeeding limitation year following retirement exceed the 415(b) limit, as increased by the cost of living provisions in IRC §415(d) for increasing the 415(b) limit in response to increases in inflation. If the benefit is being paid in a form other than a straight life, the applicable limit for testing the benefit must be actuarially reduced to take into account that form of benefit (other than the qualified portion of a qualified joint and survivor spousal annuity). See Treas. Reg. §1.415(b)-1(c)(5) Example 9. Note this condition cannot be satisfied if the plan does not incorporate the IRC §415(d) cost of living adjustments to the IRC §415(b) limits for limitation years following the limitation year in which the retiree severed employment. See Treas. Reg. §1.415(b)-1(c)(5) Example 7.

Bottom Line on COLA Issue

The relief contained in Treas. Reg. §1.415(b)-1(c)(5) for “automatic benefit increase features” would appear to respond to many of the concerns raised by public funds and will not require public funds potentially to reduce certain types of annuity benefits at retirement because the plan provides for subsequent increases in benefits to protect retirees from the effects of inflation. On the hand, the relief may not be available in all circumstances. Plan counsel will have to consider whether their plan’s COLA features would come under the “automatic benefit increase feature.”

Multiple Annuity Starting Date Issues

The treatment of multiple annuity starting dates in the proposed regulations implicated a number of different situations commonly faced by public sector plans and potentially created problems for many of them. Public sector plans had expressed particular concern about the requirement in the proposed regulations that, whenever testing benefits increased as a result of a circumstance giving rise to an annuity starting date subsequent to a retiree’s retirement, plans had to actuarially take into account benefits paid to the retiree prior to the most recent annuity starting date. Such requirements would have the “perverse” effect of making it more likely that the longer a participant were retired, the more likely that the participant’s benefit as increased by the circumstance giving rise to a subsequent annuity starting date would violate the applicable 415(b) limit.

While the final regulations appear to address at least one situation in a manner satisfactory to public plans, they do not appear to address many other situations in a way that is currently satisfactory. As discussed below, the final regulations appear to say the multiple annuity starting date rules will apply to those other situations but some of the rules for determining how they are to be applied have not been finalized. Treasury/IRS have taken this approach in response to numerous comments so as to allow Treasury/IRS to develop these rules. Thus, it remains unclear whether public plan concerns will be adequately addressed when the regulations are finally completed and what public plans compliance obligations will be, once the rules have been completed.

Service Following Retirement Generating an Additional Benefit Only

The multiple annuity starting date regulations, insofar as they are final, do not exempt situations in which a participant retires and commences receiving a benefit and then comes back to service and earns an additional benefit over and above the benefit which the participant had been previously been receiving, which is calculated without regard to the benefit s/he is already receiving. The final regulation, Treas. Reg. §1.415(b)-1(b)(1)(iii)(A) would appear to require that the applicable 415(b) limitations must be satisfied as of each annuity starting date “taking into account the benefits that have been or will be provided at all of the annuity starting dates.”

The difficulty presented is that Treas. Reg. §1.415(b)-1(b)(1)(iii)(A) further provides that “[i]n determining the annual benefit for such a participant as of a particular annuity starting date, the plan must actuarially adjust the past and future distributions with respect to the benefits that commenced at the other annuity starting dates.” These adjustments are to be made using the rules in Treas. Reg. §415(b)-2. However, Treas. Reg. §415(b)-2 has been reserved by Treasury/IRS for further study. Therefore, as of now, it appears that adjustments have to be made for prior distributions, but it is not known how those adjustments are to be made.

Service Following Retirement Resulting in a Benefit Recalculation

The multiple annuity starting date rules would also apply to situations in which a participant retires and starts drawing a benefit and then returns to service and subsequently retires with a benefit which takes into account both the service and salaries earned prior to the first retirement as well as the service and salaries earned prior to the second retirement.

Change in Form of Retirement

The multiple annuity starting date rules would also apply to situations in which a retiree is allowed to elect a new form of distribution. See Treas. Reg. §1.415(b)-1(b)(1)(iii)(B). (This situation is to be distinguished from situations in which the plan provides for a change in the benefit upon the occurrence of a specific event such as the death of a spouse or divorce or the death of the designated beneficiary of a joint and survivor form of benefit.)

COLA Increases

Treas. Reg. §1.415(b)-1(b)(1)(iii)(B) and (C)(2) appear to exempt increases which are not required to be accounted for pursuant to the exception for “automatic benefit increase features” in Treas. Reg. §1.415(b)-1(c)(5) discussed above.

Alternatively, COLA increases which were actuarially taken into account in the determination of the retiree’ straight life annuity at retirement for testing purposes against the 415(b) limit at that time are also exempt from the application of the multiple annuity starting date rules. See Treas. Reg. §1.415(b)-1(b)(1)(iii)(B) and (C)(1)

On the other hand, it appears the multiple annuity starting date rules will apply to other COLA increases not covered by Treas. Reg. §1.415(b)-1(b)(1)(iii)(C), such as COLA increases resulting from plan amendments.

Bottom Line on Multiple Annuity Starting Date Issues

Unless the rules reserved for future completion turn the situation around, the final regulations do not appear to respond to public plan concerns, except in the case of certain types of COLA increases.

It should be noted that, even if the multiple annuity starting date rules apply to a given situation, Treas. Reg. §1.415(d)-1(a)(4)(iii) permits a plan to test the benefits as increased under the increased IRC §415(b) limits to the benefits, so long as the benefits had met the IRC §415(b) limits prior to the increase.

415(b) Limits Apply to Benefit Accruals as Well as Benefit Payments

The proposed regulations had stipulated that defined benefit plans had to comply with the 415(b) limits not only when benefits were paid out but also as benefits were accrued. Public sector plans objected to this stipulation as administratively cumbersome for plans and as unnecessary because public sector plans are not subject to the vesting and anti-cutback rules in the Code applicable to private sector plans.

In the final regulations, Treas. Reg. 1.415(a)-1(d)(1) only provides that “...a defined benefit plan that is subject to the requirements of section 411 must preclude the possibility that any accrual under the plan will exceed the limitations of section 415.” Because governmental plans are not subject to the requirements of section 411, this language would appear to exempt governmental plans from the accrual requirement. See also Treas. Reg. §1.415(b)-1(a)(7)(iii).

Bottom Line on Benefit Accrual Issue

The concerns of public plans appear to have been met on this issue.

Increase in 415(b) Limit for Persons Retiring After Age 65

The proposed regulations effectively foreclosed increasing the applicable 415(b) limit for public sector plan participants who retired after age 65 because such increase was only permitted

where the plan actuarially increased benefits accrued at age 65 for the “delay” in payment until a later date. Public sector plans vigorously argued that public plans are not subject to the private sector plan rules which require such actuarial increases and typically do not provide for such increases and limiting the increase in the limit to such cases is inconsistent with the statutory language which contemplates such increase in the limitation.

Although the final regulations did undergo a major rewrite, Treasury/IRS appear to have rejected public plan arguments in the explanatory preamble to the regulations, saying an increase is “not appropriate” but not explaining why (even though an increase is actuarially appropriate given the diminution in life expectancy as a participant continues to work past 65).

The actual regulatory language in Treas. Reg. §1.415(b)-1(e) seems a little more circumscribed. What it seems to say is that there can be an actuarial increase in the 415(b) dollar limit for benefits commencing after age 65, provided no benefit is immediately payable at age 65. In other words, it appears that if the plan has a flat prohibition against a participant taking a benefit before a severance of employment, then the limit can increase if the participant only severs employment after age 65. On the other hand, if the plan allows a participant to commence receiving benefits at age 65 even if there has been no severance of employment, then the dollar limit effectively cannot rise unless the plan actuarially increases the benefit accrued at age 65 for the “delay” in payment until the member actually severs employment (also disregarding any additional benefits accrued after age 65). Thus, in order to get the benefit of the increase in the 415(b) limit for benefits commencing after age 65, it would appear that a governmental plan must not have any provision giving participants who attain age 65 an option to remain in service and start collecting his/her benefit as an alternative to continuing to accrue benefits and deferring any commencement of the benefit until a subsequent date after age 65. If the governmental plan does provide that option, then the 415(b) limitation cannot go up unless the plan is atypical in providing for actuarial increases in the benefit accrued at age 65 for the “delay” in payment.

Bottom Line on Over Age 65 Issue

The actual language of the final regulations may, in fact, be helpful in some situations. However, bear in mind that Treasury/IRS say they have rejected the concern expressed by public plans.

Definition of Compensation

Public sector plans are not subject to the defined benefit compensation limitation in 415(b). However, public sector defined contribution plans are subject to the defined contribution compensation limit in 415(c). For this reason, public sector plans expressed concern with what they considered the unduly restrictive way in which the proposed regulations defined compensation for the purposes of the 415 compensation limitations. Specifically, public plans were concerned with proposals to exclude certain types of employer payments from the definition of compensation where the payments are made after severance of employment.

Under the final regulations, except as specifically provided, payments must be made within the limitation year and prior to severance from employment in order to be considered

compensation which may be taken into account for a particular limitation year. See Treasury Reg. §1.415(c)-1(e). There is an exception for certain minor timing differences due to the timing of pay periods. There is an exception for payments of regular compensation provided payment is made within 2 1/2 months after severance or by the end of the limitation year which includes the date of severance, whichever is later. There is a similar exception for payments for unused leave, provided the amounts would have been included in the definition of compensation, had they been paid prior to severance. There is no exception for any other form of severance pay paid after severance of employment. Treasury/IRS have provided, however, that, when applying the exceptions, governmental plans have the option of substituting the calendar year in which severance occurs in place of the limitation year in which severance occurs. See Treas. Reg. §1.415(c)-1(e)(5).

It may be of interest that severance from employment is defined in Treas. Reg. §1.415(a)-1(f)(5). Note that a severance of employment does not occur when an employee ceases to be an employer maintaining if the employee has a “change of employment” and the employee’s new employer is also an employer maintaining the plan. How this is applied will depend upon all the facts and circumstances.

Bottom Line on Compensation Issue

There is some relief in the final regulations but plan counsel will have to evaluate whether it works in the circumstances of their plan.

Delayed Effective Date/Grandfathering

Treas. Reg. §1.415(a)-1(g) provides a delayed effective date for governmental plans. The new regs will apply to limitation years that begin more than 90 days after the close of the first regular legislative session of the applicable legislative body that begins on or after July 1, 2007. However, plans can apply the provisions for limitation years beginning on or after July 1, 2007. There is also a grandfathering provision for benefits payable under the plan as of the end of the limitation year that is immediately prior to the effective date of the final regulations provided the applicable provisions were adopted and in effect before April 5, 2007 and met then existing statutes, regs and regulatory guidance.

Bottom Line on Delayed Effective Date/Grandfathering

There is some relief here. Plan counsel will have to evaluate the extent to which it is helpful.