

**Federal Update 2005-23**  
**(NCTR, NASRA, and NCPERS sent these comments to the IRS about the proposed regulations on Section 415.)**

July 25, 2005

**SENT VIA COURIER AND ELECTRONIC DELIVERY ([www.irs.gov/regs](http://www.irs.gov/regs))**

CC:PA:LPD:PR(REG-130241-04)

Courier's Desk

Internal Revenue Service

1111 Constitution Avenue NW

Washington, DC 20044

Re: (1) Comments on Proposed Regulations under Code Section 415  
(2) Request to Speak at August 17 Hearing

Ladies and Gentlemen:

We appreciate the opportunity to submit comments on the proposed regulations under Code Section 415 (REG-130241-04) on behalf of the National Council on Teacher Retirement (NCTR), the National Association of State Retirement Administrators (NASRA), and the National Conference of Public Employee Retirement Systems (NCPERS). We also request that one or more representatives of our groups be permitted to speak at the public hearing scheduled for August 17, 2005 with respect to the topics outlined in this letter.

NCTR's membership consists of 75 state and local government retirement systems that include teachers and other public employees. NASRA members are the directors of the nation's state, territorial, and largest statewide public retirement systems. Established in 1941, NCPERS represents over 500 public sector pension funds and provides education to trustees, administrators and public officials. Together, our members, which are principally defined benefit plans, serve over 17 million working and retired state and local government workers and oversee \$2 trillion in assets.

Our comments are as follows:

General Comments

Extension of Time for Comments

The proposed section 415 regulation package was issued at the very end of May. Comments have been required to be received by July 25. The public hearing is scheduled for August 17, with requests to speak and outlines due on July 27.

We respectfully submit this schedule is extremely cramped, particularly when considered in light of the complexity of the subject matter, the long period during which existing regulations had not been amended, and the fact that the period for comments and public hearing falls wholly within the summer vacation period.

In the case of public sector plans, many of the matters covered by the proposed regulations are typically handled by the plans' actuaries and other professional advisors who by and large are not in-house employees. Any opportunity to meaningfully comment on the regulations is subject to the ability of plans to consult with their actuaries and other professionals and to form an understanding of how the proposed regulations will affect their plans.

We would respectfully but strenuously urge consideration be given to extending the period for comments and delaying the public hearing on the proposed regulations until November or December so that affected plans can have sufficient time to review the proposals in depth, evaluate their impact on their particular circumstances, and prepare adequate responsive comments.

#### Extended Period for Governmental Plans To Comply with Final Regulations

The special circumstances of state and local governmental plans with respect to their ability to obtain amendments to bring them into compliance with federal tax law requirements have been given recognition in final regulations previously issued by the Department of Treasury and the Service. Given that final regulations interpreting section 415 may represent substantially new guidance on a number of significant matters, state and local governments will require a certain amount of time to amend their plans to bring them into compliance with the final regulations.

We urge the final regulations include a deferred effective date for implementation by governmental plans to take into account their unique circumstances.

#### Comments Relating to Defined Benefit Limitations

##### Treatment of Defined Benefit Plan COLAs

A defined benefit pension plan is in almost all respects a superior vehicle for providing retirement security to workers, particularly the long service employees who populate the work forces of state and local governments. Benefits are paid pursuant to fixed formulas which take into account the worker's years of service and final average salary and are not subject to reduction because of adverse results in the capital markets. The funds of the plan are professionally managed on an efficient and low-cost basis which maximizes overall plan return. In the public sector, benefits are typically paid in the form of lifetime annuities which pool mortality risks and assure retired participants never reach a point where they have outlived their retirement savings.

That said, it must be recognized that even very modest inflation can ultimately have a significant negative impact upon the purchasing power of a pensioner enjoying an extended period of retirement. For this reason, to mitigate the effects of inflation over time, many defined benefit plans, particularly governmental defined benefit plans, provide a variety of built-in mechanisms, or COLAs (cost of living adjustments), to compensate retirees for the effects of inflation. These mechanisms have enabled countless pensioners to withstand quite successfully the potentially devastating effects of inflation during an extended retirement.

The salutary benefit of COLA mechanisms in defined benefit pension plans was brought to the attention of the Department of Treasury and the Internal Revenue Service when regulations were proposed interpreting Code section 401(a)(9) relating to minimum distributions. The final regulations (Treas. Reg. §1.401(a)(9)-6 (Q&A 14)) specifically permit a variety of COLA

mechanisms allowing pensions to be increased during the retirement years of plan participants without violating the non-increasing benefit rule.

Unfortunately, the current proposed regulations appear to have taken a position at least with respect to fixed percentage COLAs which is likely to be detrimental to the inclusion of COLA mechanisms in defined benefit plans. Specifically, Example 6 in Prop. Treas. Reg. §1.415(b)-1(c)(5) would appear to have adopted the position of PLR 2004522039 (September 30, 2004) that a plan must actuarially convert a fixed percentage COLA into a straight life annuity which is to be then added into the annuity benefit tested under the applicable dollar limit at the time of commencement. This position may cause many benefits otherwise well under the applicable dollar limit to exceed the limit merely because the plan happens to provide that form of COLA protection. In Example 6, a \$138,600 annual benefit otherwise well below the applicable limit was determined to exceed the limit because the plan's very modest 2% COLA had to be actuarially converted into a straight life annuity which then had to be added to the annuity benefit being tested.

This approach is contrary to prior long-standing understandings of Code section 415 that a provision for COLA increases is not taken into account at the time an annuity benefit commences. Rather, testing is to occur only when the annuity benefit is increased pursuant to the COLA provision. Under this understanding, the annuity benefit as increased by the COLA provision is tested in the year of the increase against the limit in effect at the time of the increase. This approach is simple and straightforward and would not result in reductions in promised benefits merely because the plan provides protection from inflation through a fixed COLA.

No guidance is provided indicating whether the position of Example 6 applies to any forms of COLAs permitted under Treas. Reg. §1.401(a)(9)-6 (Q&A 14) other than fixed percentage COLAs. Assuming the rule of Example 6 applies only to fixed percentage COLAs, it creates an arbitrary penalty, inasmuch as fixed percentage COLAs represent but one of a number of perfectly legitimate ways in which participants can be shielded from the effects of inflation during their retirement years.

If, on the other hand, the rule of Example 6 is to be applied to all forms of COLA, much more guidance must be provided to enable plans to implement it.

But we would strenuously urge the Department and the Service not pursue the course apparently adopted in the proposed regulations. We cannot believe Congress intended to penalize participants in defined benefit plans providing COLA protection in the manner described in Example 6. We cannot believe Congress intended a participant's benefit, otherwise within the applicable dollar limit, is to be limited at the time of the participant's benefit commences merely because the participant is or may be entitled later on to receive COLA increases in the future, when undoubtedly the applicable dollar limits will have risen and the participant's benefit at that time will, even with the COLA increase, be under the applicable dollar limit as increased. We believe Congress well understood the need for plans to provide protection against the ravages of inflation and intended an increase in benefits would only be tested at the time the increase is implemented.

The proposed approach, if adopted will have perverse effects. It will be difficult, if not impossible, to explain to affected participants why their benefits at retirement had to be reduced currently merely because they may be entitled to receive COLA increases in the future. Participants affected by this approach may even seek to renounce their COLA protection in order to have their

benefits at retirement increased. (Even if their benefits, as reduced by this approach, were subsequently allowed to increase pursuant to the “safe harbor” methodology provided in Prop. Treas. Reg. §1.415(d)-1(a)(5), it could take several years, if ever, before their annual benefit would exceed the annual benefit without COLA protection permitted to be paid under the regulations.) Moreover, there is no assurance this problem will be limited to the very highly compensated participants, inasmuch as the dollar limitations are required to be significantly reduced for participants retiring prior to age 62 (as is the case with most public employees).

We, therefore, respectfully urge that the approach in Example 6, whether intended to apply only to fixed COLAs or all forms of COLA protection, be reconsidered. We respectfully suggest that the Department and the Service instead consider a rule under which annuity benefits are tested at commencement without taking into account COLA protection. Thereafter, whenever a benefit is increased pursuant to a COLA mechanism, the increased benefit is permissible so long as it does not exceed the applicable limits at the time of the increase. Or at the very least, Example 6 should be made one of several permitted ways in which a plan having a COLA mechanism may elect to comply with Code section 415(b).

Should the Department and Service determine to proceed with the adoption of Example 6, we respectfully request that, at a minimum, the existing COLA mechanism of public sector defined benefit plan be grandfathered so as to avoid any conflict with state constitutional or statutory guarantees of existing benefits.

#### The Proposed Regulation on Multiple Annuity Starting Dates

We have substantial concerns with the multiple annuity starting date proposal, Prop. Treas. Reg. §1.415(b)-2. By its terms, it would appear to apply to any number of perfectly legitimate situations in which a participant’s annuity benefit which had previously been determined to be under the applicable 415(b) limitations at the time of commencement might be increased, such as through a COLA increase, a legislated benefit improvement for retired participants (including an ad hoc COLA to restore the purchasing power of benefits), additional accruals resulting from a return to service following retirement, and change in the form of benefit following divorce or death of spouse.

Instead of merely testing the benefit as increased under the applicable limit at the time of the increase, the proposal requires, among other things, for the plan to take into account the value of benefits previously paid, even though the participant’s benefit had previously passed muster under the applicable 415(b) limits at the time of retirement. This has the perverse effect of depriving retirees who have already received benefits under the plan from receiving the full benefit of any increase even if the benefit as increased is under the applicable limitations at the time the increase takes effect. Indeed, under the proposal, the older the retiree is and the more benefits the retiree has received, the less likely it will be the retiree can receive any increase in benefits.

We respectfully submit the rule should be reconsidered so as to allow a benefit as increased to pass if the benefit as increased passes the applicable limitations at the time the increased benefit commences. If the Department and the Service believe that the foregoing is not adequate to deal with abusive situations involving, for example, lump sums, we would respectfully suggest that special regulations be drafted to address them, rather than visiting a draconian rule on commonplace legitimate increases in annuity benefits taking place after participants have retired.

### Increasing the Defined Benefit Limit After Age 65

Code section 415(b)(2)(D) clearly contemplates that the 415(b) dollar limitation is to be adjusted upward in those cases where a participant's benefits does not commence until after age 65. Unfortunately, the provision within the proposed regulations for calculating the increase in the dollar limitation effectively precludes many governmental defined benefit plans from increasing the dollar limitation in such cases.

Specifically, under Prop Treas. Reg. §1.415(b)-1(e)(1), the dollar limit after age 65 is to be the lesser of two numbers. The first of the two numbers is only greater than the dollar limit at 65 where the plan actuarially increases the participant's benefit to reflect a delay in payment until after age 65. If a plan, such as most public employee retirement systems, does not increase a participant's benefit for delay in payment, the first of the two numbers always remains at the dollar limit at age 65. And since the dollar limit under the provision cannot move above the lesser of the two numbers, the dollar limit must remain the dollar limit at age 65. This is clearly not what Congress intended.

Public sector plans do not typically actuarially increase benefits if payment does not commence until after age 65. First, public sector plans are not subject to such rules as may apply to private sector plans requiring the latter plans to actuarially increase benefits for their participants where payment does not commence by age 65. Thus, they are not legally required to provide such increases. Second, there is no practical need to provide for such increases. Except in odd cases where a retired public employee perversely declines to commence receiving benefits for which the employee is otherwise eligible, eligible public employees typically commence receiving their benefits as soon as they leave service. The reason participants in public employee defined benefit plans over age 65 may not be drawing benefits is because they are continuing to work and continuing to accrue additional benefits. Surely, participants who continue to work after age 65 and continue to accrue benefits should not be constrained by the dollar limit at age 65 but should be subject to a higher dollar limit which takes into account the fact their benefits will eventually commence at an age later than age 65.

We respectfully submit the test in Prop Treas. Reg. §1.415(b)-1(e)(1) be reconsidered.

### Application of IRC §415(b) to Benefit Accruals

Under the express terms of Code section 415(a)(1)(A), the 415(b) limits are to be applied to the benefits provided by defined benefit plans when those benefits are paid. Accordingly, insofar as the language of Prop. Treas. Reg. §1.415(a)-1(d)(1) may bar a defined benefit plan from merely "accruing" a benefit in excess of the IRC §415(b) limitations, that language is not required by statute or even contemplated by it.<sup>1</sup> Even if such a bar were considered necessary by the Department and the Service to implement some rule applicable to private sector plans, it plainly ought to be inapplicable to governmental plans which are not subject such rule.

We respectfully submit that the language barring on accruals in excess of the 415(b) limitations be deleted or at least modified so as not to apply to governmental plans.

---

<sup>1</sup> Inasmuch as the 415(b) limitations depend upon the age at retirement, the form of payment selected by the participant, and a variety of other factors, governmental plans have no understanding of how a bar on accruals would be implemented in any event without substantial guidance from the Department and the Service as to exactly how it is supposed to work.

Certain Determinations Using Factors Described in Code section 411(c)(2)(B) and (C)

Prop. Treas. Reg. §§1.415(b)-1(b)(2)(iii) and 1.415(b)-1(b)(2)(v) require certain calculations to be done using factors described in Code section 411(c)(2)(B) and (C).

We respectfully request guidance be provided which takes into account the fact that governmental plans are not subject to those provisions and which would allow government plans to make the calculations without having to resort to those provisions and the regulations promulgated thereunder.

IRC §§415(b)(10), 415(m) and 415(n)

The undersigned organizations do not believe there is any current need for interpretative guidance on Code sections 415(b)(10), 415(m) or 415(n).

Comments Relating to Other Matters

Although governmental defined benefit plans may not be affected by the rules in the proposed regulations relating to the determination of compensation for 415 testing purposes because governmental defined benefit plans are not subject to the 100% of compensation test under 415(b), we have some familiarity with the circumstances of our participating employers and believe that there is one item which cries out for reconsideration in this area.

Exclusion of Termination and Similar Payments from the Definition of Compensation

Specifically, the provisions of Prop. Treas. Reg. 1.415(c)-2(e) would exclude from the definition of compensation for Code section 415, certain payments made by an employer to a departing employee after severance of employment. These provisions, we respectfully submit, are unduly restrictive and very likely impractical to implement on a fair basis.

To take but one example, the proposal would exclude fixed dollar termination payments to which a departing employee might be fully entitled under his/her contract or collective bargaining agreement, merely because payment happens to occur after severance of employment. Under the proposal, in order for such payment to be included, the employer would somehow have to be able to generate the payment no later than the employee's last day. Even one day later and all is lost. This is only an invitation to disaster for those employees who might wish to have all or a portion of the payment contributed to their defined contribution plan.

There is no reason why the 2 1/2 month rule cannot be extended to all payments to which a departing employee may be entitled. Indeed, applying the 2 1/2 month rule to all payments would simply recognize the practical steps employers have to take to verify that the employees have severed employment, to calculate the amount to which they are entitled, and to arrange for payment. Saying some payments can be included while others cannot would only serve to create needless traps for the unwary and require needless haste on the part of employers wishing to assist departing employees who might wish to contribute all or a portion of some well earned item of compensation into their defined contribution plan.

Conclusion

We respectfully request consideration of the foregoing comments and would be happy to supply whatever additional information or commentary that the Department or Service might require regarding same. As stated above, we also respectfully request permission to speak at the August 17th hearing in order to discuss the topics covered above.

Yours truly,

Cynthia L. Moore  
NCTR  
703-243-1667

Fred Nesbitt/Hank Kim  
NCPERS  
202-624-1458

Jeannine Markoe Raymond  
NASRA  
202-624-1417