Federal Update 2005-26

August 31, 2005

TO: NCTR Membership

FROM: Cindie Moore, NCTR
Wayne Schneider, New York State Teachers' Retirement System

RE: Treatment of COLAs among Top Issues at IRS Hearing on § 415 Regs

Introduction

Representatives of public plans and other organizations gave feedback to IRS and Treasury officials during a hearing on August 17 about the proposed 415 regulations. Dave Stella, Deputy Secretary of the Wisconsin Department of Employee Trust Funds, spoke on behalf of NCTR, the National Association of State Retirement Administrators (NASRA), and the National Conference of Public Employee Retirement Systems (NCPERS). In addition, Mr. Stella provided the officials with a joint letter signed by 11 organizations with an interest in public pension issues.

Mr. Stella and the other witnesses raised a variety of issues, including the following:

Multiple Annuity Starting Dates
COLAs
Post-Termination Pay
Increasing Defined Benefit Limit after Age 65

We will discuss IRS' proposal for each issue, explain the concern, and provide a possible solution. We will then make concluding comments.

Multiple Annuity Starting Dates

Proposal. The proposed regs would set up a new and complicated set of calculations for annuities with multiple annuity starting dates (MASD). The rules would apply in situations where a participant has received one or more distributions in limitation years: (1) prior to an increase in the accrued benefit during the current limitation year, or (2) prior to the annuity starting date (ASD) for a distribution that begins during the current limitation year.

These situations might take place as a result of:

- COLAs
- Legislated increases in retiree benefits

- QDRO's (qualified domestic relations orders or similar orders)
- Post-retirement benefit increases due to an additional benefit accrual obtained as a result of a return to service

Under the proposed regs, the annual benefit subject to the 415 dollar limit at a specified determination date, when there are MASDs, is the sum of: the accrued benefit that has not commenced; the annual benefit determined for any distribution with an ASD that occurs within the current limitation year and on or before the current determination date; the annual benefit determined for any remaining amounts payable under a distribution with an ASD that commenced in a prior year; and the annual benefit attributable to prior distributions.

Concern. Mr. Stella and other witnesses pointed out that the proposal would effectively reduce the 415 dollar limit for anyone whose benefit was subject to MASD. As NCTR, NASRA, and NCPERS pointed out in their July 25 letter to IRS and Treasury: "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."

Solution. IRS should allow an increased benefit to pass the 415 testing if the benefit as increased passes the applicable limit at the time the increased benefit commences.

COLAs

The proposed regs raise two concerns with respect to cost of living adjustments (COLAs).

General Proposal for COLAs. In general, as discussed above, the proposed regs indicate that a COLA must satisfy the 415 dollar limits using the MASD rules.

Concern. Because of the required adjustment of payments received to date under the MASD rules (see above), participants who have been in pay status a very long time will not be able to receive any adjustment under the MASD rules.

Solution. The sole factor when a plan administrator tests a benefit should be whether the amount of the adjustment causes the amount of the benefit to exceed the 415 dollar limit in effect for that year (as adjusted for COLAs).

* * * * *

Proposal Affecting Fixed Percentage COLAs. Example 6 of the proposed regs would appear to have adopted the position of IRS Private Letter Ruling (PLR) 2004522039 (September 30, 2004) that a plan must actuarially convert a fixed percentage COLA into a straight life annuity that is to be then added into the annuity benefit tested under the applicable 415 dollar limit at the time of commencement.

Concern. IRS' proposed approach may cause many benefits otherwise well under the applicable 415 dollar limit to exceed the limit merely because the plan happens to provide COLA protection in the form of a fixed percentage. Note that the proposed regs are not clear whether the approach for fixed percentage COLAs applies to other types of COLAs.

Solution. IRS should adopt 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 of the proposed regs should be only one of several permitted ways in which a plan having a COLA mechanism may elect to comply with the 415 dollar limits.

Post-Termination Pay

Proposal. Under the proposed regs, amounts received following termination from employment are not treated as compensation for 415 purposes unless the compensation is paid within 2 ½ months after termination and either would have been paid if the participant had continued in employment or paid as bona fide sick, vacation, or other leave. (Note that this proposal only affects governmental defined contribution plans, as governmental defined benefit plans are exempt from the 100% of compensation test in IRC §415(b).)

Concern. First, the time period of 2 ½ months is not necessarily long enough for a payroll department to fully process the final compensation of an individual terminating from service. Second, the proposed regs are not clear about the type of compensation that qualifies for the exception, especially because many payroll systems don't distinguish between types of compensation. Many witnesses at the hearing expressed concerns over the practical difficulties in distinguishing which compensation could be used as 415 compensation and offered a variety of approaches for identifying permissible compensation.

Solution. NCTR, NASRA, and NCPERS proposed that all types of post-termination pay be treated as 415 compensation. They did not comment on the deadline for making such payments. One approach for addressing the deadline might be to treat all payments as 415 compensation provided that they are made (1) during the limitation year in which the participant severs employment, (2) within 2 ½ months of severance of

employment or (3) within the calendar year of severance from employment, whichever allows the longest period.

Increasing Defined Benefit Limit after Age 65

Proposal. IRC §415(b)(2)(D) allows the IRC §415(b) dollar limitation to be increased for those participants who commence receiving their benefits after age 65. The methodology for increasing the limitation, however, is to be prescribed by the Secretary of the Treasury through regulations. Prop. Treas. Reg. §1.415(b)-1 would implement this provision by requiring that the increased dollar limitation for such participants to be the lesser of two numbers. The first number is determined by reference to the amount by which a plan actuarially increases the benefit payable at age 65 to compensate the participant for delaying the commencement of receipt of that benefit until some point after age 65. The second number is the amount by which the dollar limitation may be actuarially increased using a 5% interest rate assumption and the mortality tables prescribed by the Department of the Treasury.

Concern. The difficulty with this proposal for most governmental plans is that they do not actuarially increase a participant's benefits accrued at age 65 if the participant continues to work and only commences receiving benefits at some point after age 65. Because most governmental plan benefits do not actuarially increase participants' benefits accrued at age 65 to compensate for the delay in payment until a later date, the first of the two numbers discussed above in the case of these governmental plans can never be more than the dollar limitation at age 65. Because the proposed regulation states that the dollar limitation after age 65 must always be the lesser of the two numbers discussed above, the post-age 65 dollar limitation can never increase above the dollar limitation at age 65 for these plans. This result appears to be flatly contrary to the result mandated by statute, namely, the dollar limitation is increased for participants who do not commence receiving benefits until after age 65. While there may be very few, if any, participants in governmental plans who might accrue a benefit greater than the dollar limitation at age 65, it remains preferable to have the proposed regulation rewritten so as assure the 415(b) dollar limitation will increase for those participants who commence benefits after age 65, particularly since it cannot be known whether future 415 legislation might lower the dollar limitation.

Solution. The solution would be to modify the lower of the two number approach in the proposed regs. Plans should be allowed to increase the dollar limitation for participants retiring after age 65 using the 5% interest rate assumption and Treasury's mortality tables. Those plans which do actuarially increase benefits accrued at age 65 to compensate for a delay in payment until after age 65, however, could be given the option to use the methodology to determine the increase in the dollar limit if it produced a lower number than the number produced by using the 5% interest rate assumption and Treasury's mortality tables. Eliminating the mandatory use of the first number would eliminate the possibility that the dollar limitation could not increase.

Concluding Remarks

During the hearing, an IRS representative announced that comments submitted during the next couple months will be considered. Thus, if NCTR members would like to write IRS about the foregoing points or others, they should address their comments to:

Mr. Vernon Carter and Ms. Linda Marshall
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington DC 20044.

NCTR members should include the reference code, CC:PA:LPD:PR (REG-130241-04), at the beginning of their comments.

NCTR and other groups will seek a meeting about the proposed regs with IRS and Treasury officials during the next few weeks to follow up about their concerns.