AMERICAN ACADEMY *of* ACTUARIES

August 11, 2005

Ms. Linda S. F. Marshall
Office of the Division Counsel/Associate Chief Counsel
CC:PA:LPD:PR (REG-130241-04)
Room 5203
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

Dear Ms. Marshall:

On behalf of the Pension Practice Council of the American Academy of Actuaries,[1] I would like to submit the following comments and requests for clarification on proposed regulations to amend Internal Revenue Code Sec. 415 with respect to limitations on benefits and contributions for qualified plans.

Multiple annuity starting dates. After examining the proposed regulations, we have created a number of examples that we believe illustrate a fundamental problem with the methodology in the proposed regulations to convert past payments to current offsets to the Sec. 415 limit. As an alternative, we suggest determining how much of the Sec. 415 limit was used at initial retirement, and then making sure that it is offset from the Sec. 415 limit at any subsequent retirement / benefit change date. While we recognize that there are issues the that concern the IRS, we believe that there are ways to work around them without achieving the undesired consequences illustrated by the examples below.

Example #1
The way we read the cost-of-living-adjustment (COLA) provisions in the proposed regulations, it looks as if the safe harbor adjustment in Sec. 1.415(d)-1(a)(5) is very narrow. It would seem to apply to increases that were already part of the plan formula and are now payable because the Sec. 415 limit increased. It does not seem to apply to any other increase, such as an ad-hoc COLA. Accordingly, we would have to use the methodology in Sec. 1.415(b)-2 relating to the multiple annuity starting dates. These provisions apply when somebody has already received payments and receives an increase in the accrued benefit during the current year. An ad-hoc COLA presumably constitutes an increase in the accrued benefit during the current year.

The current 415 limit is compared to the sum of:

(A) The new accrual that will be paid beginning in the current year
(B) Any benefit that started to be paid in the current year before the payment of (A)
(C) The remaining payments of any benefit already in pay status
(D) The annuitized value of past payments

Plan participant "X" retires in 1/1/1986 at age 55 with an annual benefit of $25,000. The employer decides, after time, to give an ad-hoc COLA to retirees effective 1/1/2008. Plan participant "X" is slated to get a relatively modest 10 percent increase in benefits. However, this benefit must first be tested for Sec. 415 compliance. Plan

[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis, and serves as the public information organization for the profession. The Academy regularly prepares testimony for Congress, provides information to federal officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also supports the development and enforcement of actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

participant “X” has collected $25,000 each year for 22 years. We must calculate the annuitized value of past payments and add it to $25,000 in order to determine how much of the Sec. 415 limit is used up for this 77-year old participant. Under the proposed regulations, the least punitive actuarial basis that can be used is the statutory basis of 5 percent and Sec. 417(e) mortality. On this basis, the accumulated value of 22 years of payments is 50.10 x $25,000 = $1,252,454. Converting this to an annuity at age 77 provides $1,252,454 / 7.9149 = $158,240. This value is added to the $25,000 annuity to get $183,240 — i.e., the value of what he has already received plus what he is scheduled to receive going forward is equivalent to $183,240 per year beginning at age 77. We now compare this to an age 77 Sec. 415 limit. Assuming 2.5 percent inflation, the dollar limit will be $180,000 in 2008. This could be actuarially increased to age 77 based on the less generous of plan factors and 5 percent GATT. However, if this plan is like most plans, there is no actuarial increase post-65, so the plan's factors provide no increase. Thus, the Sec. 415 limit is only $180,000 and “X” cannot receive an increase.

Next, we can modify the problem and assume that the plan does provide an actuarial increase. In this case, the dollar limit is very high, so we don't have to worry about it. However, the final average earnings limit also applies. Consumer Price Index (CPI) increases from 1986-2007 are estimated at 86 percent. Thus, “X” cannot receive more than 86 percent above his last FA3. Even before the ad-hoc COLA, “X” is deemed to be receiving $183,240. Thus, if the employee’s FA3 was $98,500 or less at retirement back in 1986, he would not be entitled to any ad-hoc COLA. The older you are the more restrictive it gets.

The IRS can avoid this problem if it modifies the regulations to clarify that ad-hoc COLAs qualify for the safe harbor.

The same problem would occur if a cashout were offered (or other form of payment change) to retirees currently in pay status. Since the individual in the example is already over the Sec. 415 limit, he cannot have any form of payment change without an impermissible forfeiture.

Example #2

An employer sponsors two plans, with similar provisions. Plan participant “Y” participated in plan A for part of his career and in plan B for the rest of his career. The plans reduce benefits 6 percent per year from age 65. Plan participant “Y” retires in 2005 at age 62 after having accrued $125,000 in plan A and $55,000 in plan B, or $180,000 in total. He can elect to receive reduced benefits under both plans right away, in which case he will receive $147,600 = .82 x $180,000. Alternatively, he can defer commencement until 2008, at which point the limit is projected to increase to $180,000, allowing him to receive the full $180,000. A third, but less advisable, option would be to begin payments under plan A at age 62 and under plan B at age 65. Under this option, “Y” begins receiving $102,500 (.82 x $125,000) at age 62. At age 65, when plan B benefits begin, we must check to see how much of the limit is left. The plan A benefit is worth $102,500 + the accumulated value of past payments. Three years of payments of $102,500 accumulate to $336,944 based on 5 percent interest and Sec. 417(e) mortality (the least punitive basis allowable), and convert to an annuity equivalent for a 65-year old of $28,569. Thus, total payments from plan A equal $131,069. Compared to a Sec. 415 limit of $180,000, this leaves $48,931, which could be paid from plan B, rather than the $55,000 permissible. Thus, if “Y” takes payments from both plans at age 62, he is not even at the Sec. 415 limit. If he waits until 65 under both plans he is exactly at the Sec. 415 limit, and if he does something in between, he is over the Sec. 415 limit.

Example #3

Plan participant “Z” retires at age 55 and takes a lump sum cashout of his $80,000 accrued benefit. Based on a 4.75 percent interest rate and a deferred to age 65 annuity factor, he receives a lump-sum payment of $570,056. He goes to work at another company, which then acquires his former employer. He works at the new employer until age 70, at which point the cashout interest rate has risen to 8.5 percent. The $570,056, accumulated with interest at 8.5 percent and mortality from age 55 is worth $2,213,443 and equates to an annuity of $272,246, leaving no room for any additional benefit. In fact, each year he works past age 65 (assuming his new plan gives no post-65 actuarial increases), and each time the Sec. 417(e) rate increases, his maximum benefit decreases. This would seem to conflict with other code provisions. Does Sec. 415 override?

The basic philosophy behind the proposed regulations in Sec. 1.415(b)-2, multiple annuity starting dates, seems to be based on the premise of always working from the actual payments made. We have illustrated above the anomalous and unintended results. We would like to suggest that an alternative approach be permitted.

If the plan administrator's records have the annuities that commenced payment at the respective annuity starting dates, these should be used. For each annuity starting date, the annuity should be expressed as a life annuity, and then the percentage ratio of the annuity that commenced at each age should be taken to the current maximum at that age. The results would be summed up for the multiple annuity starting dates. If, for example, a participant commenced a benefit of $120,000 at age 60 three years ago, and the current limit at age 60 is $150,000, then this participant has used up 80 percent of the limit. At current age 65, the participant could collect another 20 percent of the limit, or another $34,000 commencing now (20 percent of $170,000 = $34,000). The sum could never exceed 100 percent.

We also recognize that the Department of the Treasury is concerned about capturing any subsidies in early retirement benefits and lump sums. For early retirement benefits, using the actual annuities paid would capture the early retirement subsidy.

The subsidy inherent in a lump sum could be accounted for by comparing the lump sum paid at an earlier annuity starting date with a "base lump-sum amount" for the accrued benefit based on the applicable mortality table for the annuity starting date, 5.5 percent interest, and the age at the annuity starting date. If the lump sum paid was less than the base lump-sum amount, then the underlying annuity would be used. If the lump sum paid was greater than the base lump-sum amount, then the annuity used in calculating the percentage used would be increased by the ratio of the actual lump sum paid to the base lump-sum amount.

Late retirement increases. How does the late retirement increase work when a plan provides the greater of continuing accrual and actuarial increase?

Rollovers/transfers and new conversion methodology. How will the new conversion methodology (using Sec. 411(c) (2) (C)) for rollovers/transfers to DB plans apply after the effective date of the new regulations? Are rollovers/transfers and conversions before the effective date under pre-regulation guidance? Are annuity starting dates after the effective date subject to the new regulations, even if the rollover/conversion happened much earlier?

Adjustment for commencement before age 62. The proposed regulation states that the age-adjusted dollar limit is determined as the lesser of:

> (i) The section 415(b)(1)(A) dollar limit (as adjusted pursuant to section 415(d) and §1.415(d)-1(a) for the limitation year) multiplied by the ratio of the annual amount of the immediately commencing straight life annuity under the plan (if any) to the annual amount of the straight life annuity under the plan commencing at age 62, if any (with both annual amounts determined without applying the rules of section 415); or
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> (ii) The annual amount of a straight life annuity commencing at the annuity starting date that has the same actuarial present value as a deferred straight life annuity commencing at age 62, where annual payments under the straight life annuity commencing at age 62 are equal to the dollar limitation of section 415(b)(1)(A), and where the actuarially equivalent straight life annuity is computed using a 5% interest rate and the applicable mortality table under §1.417(e)-1(d)(2) that is effective for that annuity starting date.

Sec. 415 states that the actuarial assumptions used for adjusting the dollar limit for commencement prior to age 62 are an interest rate assumption of not less than the greater of 5 percent or the rate specified in the plan, and the mortality table shall be the table prescribed by the Secretary of Treasury.

The proposed regulation does not conform to the IRC wording, as it requires the use of the plan's mortality basis in conjunction with the plan's interest rate. Consider the following example:

A plan participant has accrued a benefit of $200,000 payable at age 62. The participant elects to retire at age 55, and the plan provides for no forfeiture upon death while eligible for early retirement. The plan's actuarial equivalent basis for early retirement is the 1971 GAM Table for males and 5 percent interest. The early retirement factors are calculated using both mortality and interest. Assume that the mortality table specified by the Secretary is the one published in Revenue Ruling 2001-62. The early retirement factor at age 55, using the plan's mortality and interest basis, is .5540. The early retirement factor at age 55 on the plan's mortality and interest basis, with no adjustment for pre-retirement mortality as permitted by the proposed regulations, is .5993. The early retirement factor at age 55 using the mortality table specified by the Secretary and 5 percent interest, with no adjustment for pre-retirement mortality as permitted by the proposed regulation, is .6183. Thus, the dollar limit according to the proposed regulation would be the lesser of $101,881 (.5993 x $170,000) or $105,111 (.6183 x $170,000), or $101,881.

This result is contrary to the IRC's requirement. The proper limit according to the IRC is $105,111, thus the proposed regulation produces a result in violation of the IRC.

New rules on post-severance compensation:

- Most employers currently rely on the Sec. 415 safe harbor for W-2 Box 1 pay — not only for Sec. 415 limits, but also for nondiscrimination testing and highly compensated employee (HCE) determination — because this is a readily ascertainable figure on their payroll systems. The proposed regulations would seem to require payroll systems to be revamped to separately track and back out (i) amounts paid more than 2-1/2 months following severance from employment (e.g., bonuses and commissions paid on a quarterly or semi-annual basis) and (ii) amounts paid within the 2-1/2 month period that would not have been paid while the employee continued in employment (e.g., severance benefits). If this interpretation is correct, did the IRS consider that this approach seriously diminishes the value of the W-2 safe harbor and undermines its original objectives?

- If a plan is using the Sec. 415 safe harbor for W-2 Box 1 pay, is a severance check that is delivered on or before the last day of work included in Sec. 415 pay? Does the IRS intend a different result if the severance check is wrapped into the final paycheck and delivered shortly after the last day of work?

- Many employers pay salary continuation payments to individuals who are no longer performing services (and have no expectation of returning to work), but who remain on the payroll and are treated as active employees for health benefit coverage and other purposes. Does the IRS have a viewpoint on whether these payments are included in Sec. 415 pay?

- Can 401(k) participants make deferral elections, even though they are no longer "employees" performing services, as long as the elections are limited to Sec. 415 pay (e.g., bonuses paid within 2-1/2 months after severance from employment)?

- Does the IRS intend that military differential pay be included in Sec. 415 pay, no matter what definition of Sec. 415 the plan is using? If military reservists make deferrals from differential pay, are they reported on Form 1099 (rather than W-2)? Are they subject to average deferral percentage (ADP) testing?

- What is the effective date of the new rules governing post-severance payments? It appears to be limitation years on or after Jan. 1, 2007, with earlier reliance permissible. However, the June 2 edition of *Employee Plan News* states that these rules are "proposed effective for limitation years beginning on or after Jan. 1, 2005" — suggesting that once the regulations are finalized, this portion will apply retroactively to 2005 on a mandatory basis. Also, how does the effective date apply to Sec. 415 pay as used in nondiscrimination testing if the plan year and limitation year do not coincide?

Definition of average compensation used for determining 100 percent of highest three years of service. The proposed regulations in Sec. 1.415(b)-1(a)(5) change over 30 years of prior practice by (a) limiting the three years to years while a participant in the plan and also (b) limit compensation recognized for purposes of this limitation to the maximum compensation under IRC Sec. 401(a)(17).

With respect to (a) above, we see no new rationale for this change.

With respect to (b) above, this is a significant change from many years of past practice. On many occasions representatives of the IRS have been asked in public forums whether the Sec. 401(a)(17) limit applied to the 100 percent of highest three years' compensation limit under section Sec.415, and the answers have been uniformly that the limit does not apply. This change will have the effect of putting a ceiling of the dollar maximum on the benefit of an individual who retires beyond age 65.

For example, consider the case of a participant whose highest three final average earnings were always over the Sec. 401(a)(17) limit of $210,000, and the participant's accrued benefit payable at age 65 was equal to the Sec. 415(b) limit of $170,000. If the participant deferred retirement to age 68, the actuarially increased dollar limit under the present law would be $215,553. The proposed regulation would limit the participant to $205,000, the highest three-year average of the compensation limits. There would be more of a cutback if the participant deferred retirement to a later age.

Furthermore, it could be viewed as age discriminatory, where a participant who passes normal retirement age is not permitted to have an actuarial increase in his benefit, even if he is a terminated employee. Moreover, it is a violation of section Sec. 411(d)(6), in that the participant does not get the actuarial increase in benefit because of commencement deferred beyond normal retirement age that is required by law.

Cost of living increases. In the proposed regulation, examples are given referring to ad-hoc increases in the Sec. 415(b) dollar limit. The regulation needs to clarify that a plan that embeds in its formula cost-of-living increases not greater than the increases occurring under Section 415(d) be given the same treatment and not require an adjustment in the original benefit.

As mentioned in a letter dated July 27, 2005, we are interested in providing testimony on these proposed regulations at the hearing on August 17, 2005. If you have any questions or would like to discuss any of the Academy's comments, please contact Heather Jerbi, the Academy's senior pension policy analyst (202.785.7869; Jerbi@actuary.org).

Sincerely,

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