AMERICAN ACADEMY *of* ACTUARIES

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Harlan Weller
Government Actuary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 4024
Washington, DC 20220

David M. Ziegler
Manager
Employee Plans Actuarial Group
Internal Revenue Service
200 Constitution Avenue
Room N5655
Washington, DC 20210

Re: Application of IRC 415(b) Limits

Dear Mr. Weller and Mr. Ziegler:

The American Academy of Actuaries[1] Pension Committee has become aware of an Internal Revenue Service (IRS) position with respect to Internal Revenue Code (IRC) Section 415(b) that differs substantially from the widely held understanding of the practitioner community. In short, we understand the IRS's position to be that a plan cannot pay the full single life annuity limit ($200,000 annually in 2012) at a commencement age between 62 and 65 unless the plan provides unreduced benefits at that age. We further understand that a plan cannot without reducing the single life annuity limit pay a Qualified Joint and Survivor Annuity (QJSA) (as defined in IRC Section 417) unless the plan provides that QJSA form of benefit free (i.e., without reduction for the form of benefit).

We would like to express our concern regarding this interpretation and respectfully request clarification and/or additional guidance. In addition, we request that, if this is indeed the IRS's position, it be promulgated in a proposed regulation exposed for public comment, and applied only prospectively (with Section 411(d)(6) protection of accrued benefits) once such a regulation is finalized.

Background

IRC Section 415(b) imposes a dollar limit on benefits payable from qualified defined benefit plans. The 2012 limit is $200,000 a year for a single life annuity.
Section 415(b)(2)(C) provides that the limit is reduced for benefits that begin before age 62, and Section 415(b)(2)(B) provides that there is no adjustment for form of payment if the benefit is paid as a QJSA.

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[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

As a result of these IRC provisions, it has been widely understood that (using 2012 limits as an example) a $200,000 benefit could be paid beginning at age 62 as a qualified joint and 100 percent (or any lesser percentage at least equal to 50 percent) survivor annuity.

IRC Section 415 regulations limit the benefit that can be accrued (not simply the benefit that can be paid) to the Section 415 limit. This provision has been understood to mean that since early commencement factors and optional forms of benefit are part of the accrued Section 411(d)(6) protected benefit, and there are legislated provisions with respect to these items under Section 415, then the accrued Section 415 limited benefit at any time is really a matrix of benefits payable at different times and in different forms.

For example, assume that a participant’s accrued benefit under the plan formula (before applying the Section 415 limits) is $300,000, payable at the plan’s normal retirement age of 65. The plan pays 80 percent of the accrued benefit at age 62, and pays a 100 percent QJSA using an optional form factor of 0.9. The plan’s (pre-limit) accrued benefit payable at age 62 as a 100 percent QJSA is $300,000 * .8 * .9 = $216,000. Since the maximum benefit payable at age 62 as a 100 percent QJSA under Section 415(b) is $200,000, the accrued benefit payable at age 62 as a 100 percent QJSA has been understood to be $200,000.

Based on informal discussions with IRS officials, however, we understand that the IRS interprets the regulation (and specifically Section 1.415(b)-1(a), which limits the benefit that can accrue to the Section 415 limit) to mean that the benefit payable at age 62 is $200,000 * .8 * .9 = $144,000. This interpretation appears to consider the Section 415 limit to be an age 65 benefit payable in the form that is unreduced under the plan (typically the single life annuity), rather than considering the legislated reduction factors and QJSA form to be part of the 415 benefit. In this example, therefore, the accrued age 65 benefit is limited to $200,000 and, since the plan reduces benefits for periods before age 65 and for QJSAs, the $200,000 is then reduced using plan factors.

After learning of this interpretation, IRS representatives were asked to confirm it at the “Dialogue with IRS” session on Oct. 26, 2011, at the Conference of Consulting Actuaries meeting (the questioner focused solely on the QJSA payable at age 65 to simplify the question for discussion purposes). The IRS representatives articulated the position described above, indicated that it was an intentional change promulgated in the 2007 Section 415 regulations, and further indicated that the philosophy behind the change had to do with a comparison to the “rank and file” plan benefits (i.e., if the rank and file did not receive a free QJSA, then executives limited by Section 415 should not either). We understand that similar discussions occurred at the annual meeting of the American Society of Pension Professionals and Actuaries.

Analysis

We believe this interpretation is contrary to statute (IRC Section 415(b)), the 2007 Section 415 regulations, and common understanding of the requirements by practitioners. Many plan documents with determination letters have language that does not comport with this interpretation. In addition, if this were indeed the rule, it easily could be circumvented by restating the plan formula differently, but equivalently, without changing any participants’ benefits. We will address each of these issues in turn.

Statute

Early Commencement Reductions

We believe that this interpretation is not supported by the clear, plain language in the statute. IRC Section 415(b)(1)(a) sets forth the Section 415(b) dollar limit for an annual single life annuity of $160,000 (since adjusted with cost of living increases in accordance with Section 415(d) to $200,000 for 2012). Section 415(b)(2)(C) reads as follows, and appears only to give the secretary of Treasury the authority to prescribe reductions in the limit for early commencement at ages below 62:

> 415(b)(2)(C) Adjustment To $160,000 Limit Where Benefit Begins Before Age 62 - If the retirement income benefit under the plan begins before age 62, the determination as to whether the $160,000 limitation set forth in paragraph (1)(A) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary, by reducing the limitation of paragraph (1)(A) so that such limitation (as so reduced) equals an annual benefit (beginning when such retirement income benefit begins) which is equivalent to a $160,000 annual benefit beginning at age 62.

Reductions for QJSA Forms of Benefit

IRC Section 415(b)(2)(B) similarly appears to give the secretary of Treasury the authority to prescribe methods to convert benefits payable in a form other than a single life annuity to an equivalent single life annuity for purposes of comparison to the limits (which is equivalent to reducing the limits for optional forms that provide survivor benefits) *but clearly provides that no adjustments are to be made for qualified joint and survivor annuities*:

> 415(b)(2)(B) Adjustment For Certain Other Forms Of Benefit
> If the benefit under the plan is payable in any form other than the form described in subparagraph (A), or if the employees contribute to the plan or make rollover contributions (as defined in sections 402(c), 403(a)(4), 403(b)(8), 408(d)(3), and 457(e)(16)), the determinations as to whether the limitation described in paragraph (1) has been satisfied shall be made, in accordance with regulations prescribed by the Secretary by adjusting such benefit so that it is equivalent to the benefit described in subparagraph (A).
>
> For purposes of this subparagraph, any ancillary benefit which is not directly related to retirement income benefits shall not be taken into account; ***and that portion of any joint and survivor annuity which constitutes a qualified joint and survivor annuity (as defined in section 417) shall not be taken into account.*** **[Emphasis added].**

Regulations

No Evidence of Intent

As discussed above, we understand that the IRS believes that this treatment of the limits was a deliberate change made when the 2007 regulations were issued. But despite the drastic nature of this change (causing a 28 percent reduction from $200,000 to $144,000 for a joint and 100 percent survivor annuity payable at age 62 in the example above), it was not explicitly discussed in the preamble to either the proposed or final regulations. In addition, there is no text and there are no examples in the final regulations that clearly articulate, or even suggest, this intent. Given the substantial preambles to both the proposed and final regulations, we believe that, had the drafters of the regulation intended to make such a significant change in prevalent practice and prior guidance, their intent would have been made clear in the preamble (as well as in the text of the regulations and/or examples in the regulations).

Contrary Examples in the Regulations

The final regulations include two examples that clearly contradict this interpretation, and another that strongly suggests a contradiction.

Section *1.415(b)-1(d)(7) Examples 1 and 2*—In these examples, the plan provides that early retirement benefits are determined by reducing the accrued benefit by 4 percent for each year by which the early retirement date precedes age 65. Example 1 illustrates the effect of a free QPSA (leading to no reflection of pre-commencement mortality when determining the reduction in the Section 415 limit for commencement before age 62) but in doing so makes clear that the limit at a commencement date before age 62 is the full dollar limit (the $180,000 dollar limit in effect for 2007—when the regulations were issued—in the example) reduced from age 62, not age 65, despite the fact that the plan does not provide unreduced benefits at age 62. Example 2 makes the same point in illustrating the limit for an employee beginning benefits at age 60.5, providing that the limit is determined by reducing the $180,000 dollar limit from age 62. These examples explicitly contradict the position that the IRS intended that the limit be unreduced at age 62 only if plan benefits were unreduced at age 62.

1.415(b)-1(c)(6) Example 4—In this example, the plan provides a benefit equal to 100 percent of the participant's highest three-year average compensation. The plan also provides a 100 percent QJSA that is reduced (the reduction in the single life annuity benefit to provide the QJSA is half the full actuarial reduction), and a lump sum option that is the actuarial present value of the 100 percent QJSA (i.e., the lump sum includes the QJSA subsidy). The example makes the point that the benefit compared to the Section 415 limit is adjusted when the QJSA subsidy is included in the lump sum, and, by omission, strongly implies that the subsidy is ignored if the benefit actually is paid in the form of the 100 percent QJSA. Example 4 specifically provides the following commentary about the lump sum option requiring adjustment, and is silent on the QJSA option needing adjustment:

> The special rule that disregards the value of the survivor portion of a QJSA set forth in paragraph (c)(4)(i) of this section only applies to a benefit that is payable in the form of a qualified joint and survivor annuity. Any other form of benefit must be adjusted to a straight life annuity in accordance with paragraph (c)(1) of this section. Accordingly, because the benefit payable under the plan in the form of a single-sum distribution is actuarially equivalent to a straight life annuity that is greater than 100 percent of a participant's average compensation for the period of the participant's high-3 years of service, the limitation of section 415(b)(1)(B) has been exceeded.

Form over Substance

We also believe that enforcement of this position by the IRS could be ineffective because plan formulas simply could be restated in a manner that would allow the full dollar limit to be paid as a 100 percent QJSA at age 62. For example, consider the example discussed above—the participant's accrued benefit before reflecting Section 415 limits is $300,000, the Section 415(b) limit is $200,000, the plan's earliest commencement age is age 62, and the actuarial reduction at age 62 is 20 percent. Under the IRS's interpretation, the participant's single life annuity benefit would be limited to $160,000 (80 percent of $200,000). Such a plan could be amended, however, to change the normal retirement date to age 62, reduce the plan formula by 20 percent, and provide actuarial increases from age 62 to 65 (on the same basis as the previously applicable actuarial reductions). Such a change would not change the benefits payable to any participant who is not affected by Section 415 limits (other than perhaps vesting a few participants earlier), and thus would not violate Section 411(d)(6). At the same time, such a change would permit the $200,000 benefit to be paid at age 62 to this participant. Viewed from this perspective, instead of providing an unreduced early retirement benefit only for certain high-paid participants, the plan instead would provide an actuarially increased benefit between ages 62 and 65 for everybody *except* for certain high-paid participants. We believe that the ease with which the IRS interpretation could be circumvented is further evidence that the interpretation is not supported by the statute or intended by the regulations.

We appreciate the Treasury and the IRS giving consideration to these requests. Please contact Jessica M. Thomas, the Academy's senior pension policy analyst (202-785-7868, thomas@actuary.org) if you have any questions or would like to discuss these items further.

Respectfully submitted,

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