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Final Regulations on Maximum Benefit Limits

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On April 5, 2007, the Internal Revenue Service (IRS) issued final regulations on the limitations on benefits and contributions under qualified plans. These rules are generally found in Internal Revenue Code Section 415, and are often referred to as the “§415 limits.” Comprehensive proposed regulations were issued in May 2005 and much of this guidance remains unchanged in the final regulations. The IRS received many comments from the benefits community and reflected some, but not all, of these comments in the final regulations. While the regulations apply to all qualified retirement plans, this article will focus on the provisions affecting public sector defined benefit plans.

Some of the key provisions of interest to public plan sponsors include:

- **Cost-of-living adjustments (COLAs).** The IRS has historically taken the position that a life annuity with a COLA feature is not a straight life annuity. For the first time, regulations contain specific language allowing plans to disregard the value of an automatic COLA when testing the §415 limits at retirement—both variable- and fixed-rate COLAs. In order to take advantage of the IRS exception, an automatic COLA must meet the IRS definition of “automatic benefit increase feature,” including specific plan language regarding the application of §415 to the COLA. Automatic benefit increases that do not meet the new IRS definition must include the full value of the COLA at retirement, resulting in a lower §415 limit for the life annuity. Ad hoc and other non-automatic COLAs will be subject to the more complicated rules for multiple annuity starting dates.

This is welcome relief for many systems. However, plans will now be required to test currently paid retirement benefits annually to confirm that benefits have remained below the §415 benefit ceiling. Because the maximum §415 limit only increases in \$5,000 increments, a plan with a typical CPI increase will not necessarily track with the §415 limits.

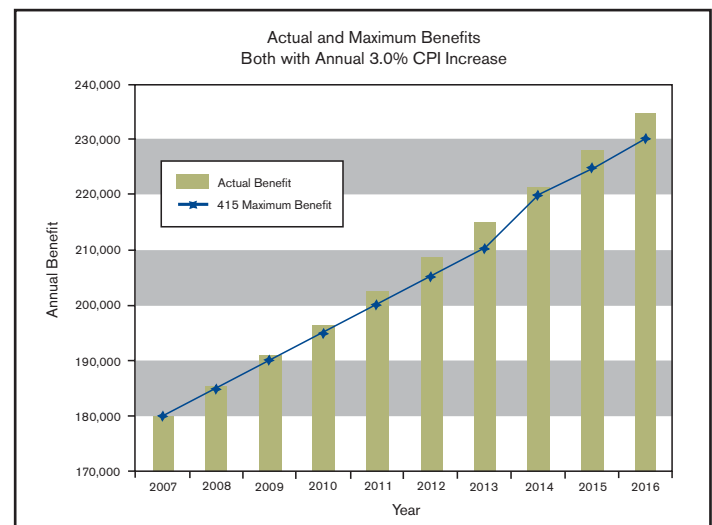
For example, consider a system that increases benefits by the CPI each year (assumed to be 3%). If a benefit starts at \$180,000 in 2007, it will be limited by the §415 benefit ceiling in future years, as shown in the accompanying graph.

§417(e) forms of payment

IRS rules distinguish “§417(e) forms of payment” from other payment forms for many purposes, including application of the §415 maximum benefit limits. These are forms of payment subject to the minimum present value requirements of §417(e)(3) and include lump-sum payments, installment payment forms, level income options, and other payment forms that can decrease during the member’s lifetime. Of special interest to public plans, this list includes partial lump-sum options and Deferred Retirement Option Plans (DROPs).

Caution – The IRS definition appears to be sufficiently broad to include most automatic COLAs, including features that increase benefits by a specified percentage or objective index such as the CPI, or that share favorable investment returns. Not included in this definition are variable annuity features that can decrease benefit payment amounts, nor forms of payment that are not payable solely as a level annuity, the so-called “§417(e) forms of payment.” (see sidebar below)

- *Adjustments for benefits commencing before age 62 or after age 65, and in payment forms other than a straight life annuity.* For 2007, the basic §415 ceiling on employer-provided benefits is \$180,000, payable as an annual amount for the lifetime of the member, with benefits commencing at any time from ages 62 through 65. Adjustments are made to this basic ceiling to reflect benefits payable before age 62, after age 65, or in a form other than a straight life annuity. The regulations clarify the methods for determining these adjustments, generally requiring that plans use the lesser of the plan’s adjustment factors and IRS-mandated (statutory) adjustment factors. However, for plans that do not offer benefits in the form of a straight life annuity (as the next section demonstrates, this includes most public plans), the limit adjustments for both age and form of payment are based solely on the statutory factors. For most annuity payment options, the IRS specifies a 5.0% interest assumption and the Applicable Mortality Table. For lump sums and other 417(e) payment forms, a more complicated three-pronged calculation is required.



- *Late retirement.* The final regulations confirm prior guidance and only allow for increased benefit limits for late retirement when the plan provides a similar increase. As a result, the maximum benefit is constant for retirement ages 62 and higher unless the plan specifically increases benefits for retirees commencing benefits after age 65. While private sector plans generally provide for increases after normal retirement age in order to meet legal requirements, few public plans contain provisions for such an increase. As a result, this guidance will primarily affect public plans. However, for a plan that does not offer a straight life annuity, one possible interpretation suggested by some practitioners would lead to disregarding the plan factors and reflecting the statutory post-age-65 increases in the maximum benefit amounts, whether or not the plan provided for such an increase.

Observation – Public plans typically require member contributions and include a minimum death benefit of the return of these contributions as a part of the normal payment form. Further, many systems include automatic cost-of-living increases. If all available single life annuity payment forms have either of these two features, a case can be made that the plan's adjustment factors should be ignored when calculating the maximum benefit amount. This approach could lead to a slightly larger benefit limit depending on the adjustment factors used by the system. The difference for benefits commencing after age 65 could be significant—7% or more per year after age 65. Because of the complexities involved, a system would be well served to consult with legal counsel—ideally with both public plan and ERISA expertise—in arriving at an appropriate interpretation.

- *Maximum lump-sum rules apply to public plans.* Special rules apply when determining the §415 maximum benefit limits for lump-sum distributions as defined in IRC Section 417(e). Public plan sponsors in the past have largely ignored the rules regarding these so-called “§417(e) forms of payment”, because plans of governmental employers are exempt from §417(e). However, the final regulations are clear that the special maximum benefit limits for lump-sum distributions apply to §417(e) forms of distribution, regardless of whether the plan is otherwise subject to payment”, because plans of governmental employers are exempt from §417(e). The ceiling on lump-sum distributions was modified by the Pension Protection Act (PPA) and was discussed in Milliman's *PERiScope* article of February 2007.

Caution – Large lump-sum payments to younger members risk exceeding the maximum benefit limits and should be reviewed carefully in light of the new rules. The special lump-sum rules also apply when determining the annuity equivalent of partial lump-sum payments. This potentially larger equivalent annuity is then added to the annuity portion of the payment when testing for compliance with §415. This could also be significant for DROPs.

- *Qualified joint and survivor benefits.* Consistent with the proposed regulations, a plan need not make an adjustment for any portion of a benefit paid in the form of a QJSA (qualified joint and survivor options with 50% or more continuing to one's spouse). This is true even if a part of the benefit is paid in another form, such as a partial lump sum.

- *Social Security supplements.* The annual benefit subject to §415 includes only benefits that are related to retirement. The final regulations confirm that a supplemental Social Security benefit is related to retirement, and its value must be reflected when testing for compliance with the maximum benefit limits.
- *Special rules for employees of police departments and fire departments.* Consistent with prior guidance, the maximum benefits payable to qualified police and fire firefighters are not reduced to reflect early commencement of benefits, provided the member had at least 15 years of such service. The final regulations confirm that this exemption applies to all employees of police and fire departments, and members of the armed forces, regardless of job classification. Note that the special rules do not apply to plan members who perform police- or fire-related duties, but who are not specifically employed by a police or fire department.

Caution – A plan's definition of safety employee may not exactly mirror the IRS definition for §415 limit purposes.

In addition, the §415 limit definition of “public safety employees” differs from the IRS guidance in Notice 2007-7, which classifies safety employees based on their training and principal duties. Further, the public safety definition under Section 845 of PPA '06 for the income tax exception from 50 to 55 differs from the definition under Section 828 of PPA '06 for the new \$3,000 tax premium benefit. Thus, a plan may need to define safety member under four different definitions for these different purposes. (See Milliman's *PERiScope* article of February 2007.)

- *Effective date.* For governmental plans, the regulations are generally effective for limitation years that begin more than 90 days after the close of the legislative session of the legislative body with authority to amend the plan that begins on or after July 1, 2007. For plans with calendar limitation years, the provisions may be applied as early as Jan. 1, 2008, if plan provisions are amended as necessary.

Grandfather rules contained in the new regulations generally apply for benefits that were earned before 2008 and based on plan terms that were in effect prior to April 5, 2007, provided the plan was in compliance with existing guidance.

More to come

The proposed rules for multiple annuity starting dates provided a lightning rod for commentary from the benefits community. The IRS continues to wrestle with this issue and has delayed final guidance until a later date. These final regulations also do not provide any additional guidance for governmental employers on the 1989 grandfather election [§415(b)(10)] or excess benefit arrangements under §415(m). Finally, further guidance is still needed on the purchase of permissive service credits under §415(n).

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This publication is intended to provide information and analysis of a general nature. Application to specific circumstances should rely on separate professional guidance. Inquiries may be directed to: Brent Banister, Editor; 1120 South 101st Street, Suite 400, Omaha, NE 68124-1088; (402) 393-9400; periscope@milliman.com

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