ASPPA
WORKING FOR AMERICA'S RETIREMENT

Comments on Proposed Regulations Relating to Limitations on Benefits and Contributions Under Qualified Plans (IRC §415)

August 10, 2005

Department of Treasury
Internal Revenue Service
REG-130241-04

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates this opportunity to comment on the proposed amendments to the regulations under Internal Revenue Code (IRC) §415 that provide guidance regarding limitations on benefits and contributions under qualified plans (Proposed Regulations). ASPPA's comments are set forth in two separate documents. This document addresses all areas of concern other than the three issues discussed in the document filed on July 25, 2005 [the application of the IRC §401(a)(17) compensation limit to IRC §415, the treatment of pre-participation service for purposes of determining a defined benefit plan participant's highest 3 years of compensation, and the effective date of the regulations].

ASPPA is a national society of retirement plan professionals. ASPPA's mission is to educate pension professionals and to preserve and enhance the private pension system. Its membership consists of approximately 5,500 actuaries, plan administrators, attorneys, CPAs, and other retirement plan experts who design, implement and maintain qualified retirement plans, especially for small to mid-size employers.

ASPPA commends the IRS and Treasury for their efforts to update the IRC §415 regulations for the various statutory changes adopted since the current final regulations were issued in 1981 and to codify the guidance provided in various Notices and Revenue Rulings since that time. This regulatory update also includes modifications to areas that have been well established by both the IRS and practitioners, and also addresses other areas of application that have not previously been identified. For reasons of both sound policy and practicality, ASPPA believes that the following issues should be addressed in the final IRC §415 regulations.

Summary of Recommendations

The following is a summary of ASPPA's recommendations. These are described in greater detail in the Discussion of Issues section.

A. With respect to multiple annuity starting dates, the annual benefit attributable to a prior distribution should be determined using the actuarial factors that were used to calculate such prior distribution and not the factors that are being used for the current distribution. In addition, ASPPA recommends that the final IRC §415 regulations include an option whereby a plan sponsor can elect to use a fixed rate to value prior distributions (*e.g.*, 5% or 5.5%).

B. The Post-severance Compensation rules [*i.e.,* the rules providing that compensation described in Proposed Regulation §1.415(c)-2(e)(3) that is paid within 2½ months after severance from employment must be included in IRC §415 compensation] should be expanded to address the following:

- Post-severance Compensation should be an optional exclusion from IRC §415 compensation. However, if such amounts must be included, then guidance should be provided to permit the exclusion of such amounts for purposes of IRC §414(s) without subjecting the definition to

nondiscrimination testing under Treas. Reg. §1.414(s)-1(d)(3);

- The application of the rule in Proposed Regulation §1.415(c)-2(e)(2) which provides a special rule for "certain *de minimis* timing differences", should be an optional provision that is separate from the general Post-severance Compensation rules and should not require a formal election by an employer;
- Post-severance Compensation that is paid in a limitation year following the limitation year in which there was a severance of employment should be permitted to be included in IRC §415 compensation only in the year in which the payment is made, unless the plan sponsor elects otherwise;
- Participants who receive plan benefits based on Post-severance Compensation in a plan year following termination of employment should be treated as terminated employees with less than 500 hours of service (and not as former employees) for purposes of IRC §401(a)(4); and
- The 2½ month period for the determination of includible Post-severance Compensation should be lengthened for governmental employers.

C. The final regulations should include a provision that clarifies that the IRC §415 (b) dollar limit for distributions made prior to age 62 not be reduced solely because of an increase in an individual's age or service.

D. The final regulations should clarify the application of the IRC §415(b) dollar limit with respect to plans with non-calendar year plan years.

E. The correction provisions for a failure of the IRC §415 annual additions limit should be added back to the final regulations and such remedial action by the employer should not require correction under the Employee Plans Compliance Resolution System (EPCRS).

F. Payments made on behalf of an individual who is on military leave (*e.g.,* differential pay) are optional and should be encouraged. Accordingly, such pay should be an optional, not mandatory, inclusion for purposes of IRC §415 compensation.

G. Additional guidance regarding service credit purchases under IRC §415(n) is needed.

H. The IRC §415 annual addition timing rules for tax-exempt and governmental employer contributions should be based on the fiscal year, not the taxable year.

I. Various additional clarifications and corrections are also recommended.

Discussion of Issues

A. The Annual Benefit Attributable to a Prior Distribution Should be Determined Using the Actuarial Assumptions as of the Prior Distribution Date

The Proposed Regulations provide rules for determining the annual benefit of a participant for purposes of applying the IRC §415 limitations when a participant has received one or more distributions in limitation years prior to the annuity starting date for a distribution that commences during the current limitation year. The Proposed Regulations provide that for such purposes, the actuarial assumptions used to calculate the straight life annuity equivalent of a prior distribution subject to IRC §417(e)(3) shall generally be based upon the applicable interest rate and applicable mortality table under IRC §417(e)(3) as of the current distribution date [Proposed Regulation §1.415-2(b)]. As a result, the value of any prior distribution will fluctuate based on the current interest rates.

T he equivalent amount of annuity benefit should be uniquely determinable at the time of the original distribution and should not fluctuate. This will ease the administration of plans and help ensure that both participants and plan sponsors are able to determine benefits that are payable under the plan. If the values of prior distributions fluctuate, then it will result in substantial uncertainty for participants and plan sponsors regarding the future value of plan benefits. Furthermore, it can create enormous practical problems in the area of funding, as well as substantial administrative burdens. For example, the calculation of required minimum distributions under IRC §401(a)(9) would be greatly complicated because the proposed rules would require a recalculation each year of the IRC §415 value of each prior minimum distribution.

One way to address these potential administrative problems would be to allow a "safe harbor interest rate" of perhaps 5.0% or 5.5%, to be used for these conversions. In reality, there will be plans that will be unable to locate old data, which could involve distributions from perhaps 25 or 30 years ago. For these plans, there would be no other practical alternative.

In addition, it is not clear how the application of this rule would be affected by IRC §411(a) (which generally prohibits a forfeiture of an accrued benefit). Under the new proposed rule, a participant's remaining accrued benefit potentially could decrease if interest rates change. It is not clear whether such a decrease would be considered a violation of the anti-forfeiture rules of IRC §411(a). Nevertheless, it is desirable from both a policy and practical perspective to implement a rule that provides certainty as to the valuation of a prior benefit distribution and prevents the inequitable results of the proposed rule.

ASPPA recommends that the annual benefit attributable to a p rior distribution be determined using the actual interest and mortality rates that were used to calculate such prior distribution [*e.g.,* the applicable interest and mortality rates (or other applicable rates) at the time of distribution of the prior benefit]. In addition, ASPPA recommends that the final IRC §415 regulations include an option whereby a plan sponsor can elect to use a fixed rate to value prior distributions (*e.g.*, 5% or 5.5%). Such an election could be made to facilitate the administration of the plan or when actual prior dates or amounts of distributions are not available.

B. Post-severance Compensation Issues

1. Post-severance Compensation Should Be an Optional Exclusion Under the IRC §415 Definition of Compensation

The Proposed Regulations provide that compensation described in §1.415(c)-2 (e)(3) that is paid within 2½ months after severance from employment must be included in IRC §415 compensation (Post-severance Compensation). Capturing Post-severance Compensation data, as distinguished from post-severance payments that are not considered Post-severance Compensation, will be a large burden for small plan sponsors. While large employers may have the resources needed to purchase sophisticated payroll systems that can distinguish between different types of post-severance pay, many small employers use simplistic bookkeeping systems or manually calculate payroll. Thus, a mandate that this separate accounting take place may disproportionately impact small employers, thereby driving up the costs of maintaining plans and discourage the maintenance or establishment of plans.

In addition, many employers do not want to provide benefits on compensation paid after severance of employment. If there is a mandate that Post-severance Compensation be taken into account, there may be situations where benefits must be provided on such amounts. This will increase administrative complexity and costs for these employers.

The Proposed Regulation also appears to impose the same rule on all Post-severance Compensation paid within 2½ months after a limitation year. Proposed Regulation §1 .415(c)-2(e)(2) does provide a special rule for "certain *de minimis* timing differences" (Final Paycheck). However, that rule permits only Final Paychecks paid in one limitation year to relate back to the prior limitation year in which the amount was earned (but not paid). Presumably, if the Final Paycheck is paid in the same limitation year in which it was earned, it would be required to be included in IRC §415 compensation because it would be considered Post-severance Compensation.

Employers should be allowed to elect whether to include Post-severance Compensation and whether to include the Final Paycheck in §415 compensation. This election will allow employers to continue their operational processes without incurring additional administrative burdens or costs. In addition, permitting this flexibility will foster operational compliance because plan sponsors can work with their service providers to best determine the easiest and most cost effective way to operate their plans in a compliant manner.

ASPPA recommends that Post-severance Compensation be an optional inclusion under the IRC §415 definition of compensation. In addition, there should be a separate option with respect to the Final Paycheck that is only

considered Post-severance Compensation due to *de minimis* timing differences.

2. No Formal Election for Amounts Contained in Final Paycheck

As stated in Section 1, above, the Proposed Regulation provides a special rule for Final Paychecks, effectively permitting such amounts to be accounted for on an accrued basis. The current regulation [Treas. Reg. §1.415-2(d)(5)(ii)] contains a similar rule and specifically provides that a formal election is not required to use the option. The Proposed Regulation does not indicate whether a formal election is required in order to use the Final Paycheck rule. A formal election would be cumbersome and impractical to implement. In addition, it would likely lead to administrative errors.

ASPPA recommends that the Proposed Regulations be modified to provide that the inclusion of amounts subject to *de minimis* timing differences (*i.e.,* the Final Paycheck) not require a formal election by an employer.

3. Post-Severance Compensation Should Be Included in Compensation in the Year of Payment Unless the Plan Sponsor Elects Otherwise

The Proposed Regulations do not include a provision, other than the Final Paycheck rule, that permits Post-severance Compensation to be accounted for on an accrued basis (*i.e.,* permitting amounts paid after the limitation year in which employment terminated to be treated as though they were paid in the limitation year in which employment terminated). However, the Treasury and IRS have inquired as to whether such a provision would be desirable.

This provision would be impractical and cumbersome, particularly for IRC §401 (k) plans subject to ADP and or ACP tests. There is a 10% penalty for ADP and ACP corrective distributions made more than 2½ months after the end of a plan year. These tests are based on plan data and compensation for the plan year. If compensation cannot be determined with certainty until 2½ months after employment has terminated, then there may not be enough time to perform the tests if any participant terminates employment near the end of a plan year.

For example, if a participant in a 401(k) plan (it does not matter if the participant is a highly compensated employee) severs employment late in December 2005 and receives Post-severance Compensation in early March 2006 (within 2½ months after severance of employment), then the ADP test would not be able to performed until that time. Preparing the calculations and processing the refunds by March 15 would be difficult, if not impossible. Refunds not processed by March 15, 2006, would be subject to a 10% penalty payable by the plan sponsor.

ASPPA recommends that,with the exception of the Final Paycheck rule, Post-severance Compensation be permitted to be included in IRC §415 compensation only for the limitation year in which the payment is made and not in an earlier limitation year containing the severance of employment date. However, ASPPA does not object to the inclusion of such a provision in the final regulations provided each sponsoring employer has the option to decide whether to implement such a provision with respect to its plan.

4. The Safe Harbor Compensation Definitions Under IRC §414(s) Should Permit Either the Inclusion or Exclusion of Post-severance 415 Compensation

If Post-severance Compensation must be included in IRC §415 compensation (*i.e.,* if ASPPA's recommendation in Section 1, above is not adopted), then it is not clear whether plan benefit compensation that excludes such amounts would be subject to nondiscrimination testing under Treas. Reg. §1.414(s)-1(d)(3). If the exclusion of Post-severance Compensation is considered an alternative definition of IRC §414(s) compensation that is subject to the nondiscrimination test, then an IRC §414(s) test would need to be performed every year. This would create an unnecessary administrative burden and expense on employers.

If plans *must* include Post-severance Compensation in IRC §414(s) compensation (*e.g.,* to avoid performing the nondiscrimination test), then it could severely impact and potentially distort ADP testing results since many employees who lost their jobs would be reluctant to defer because they need severance compensation for living expenses.

Moreover, once an employee terminates employment, an employer should be permitted to exclude the former employee from any further benefits under the plan. As a matter of consistency, employers should be allowed to exclude Post-severance Compensation without subjecting the plan to additional nondiscrimination testing.

ASPPA recommends that if Post-severance Compensation must be included in compensation for purposes of IRC §415, then guidance be issued permitting such compensation to be excluded for allocation or benefit purposes without subjecting the plan to nondiscrimination testing under IRC §414(s).

5. A Terminated Employee Should Be Considered a Current Participant in the Year that the Post-severance Compensation is Paid, if that Compensation is Used to Create a Plan Benefit

If Post-severance Compensation is compensation for purposes of IRC §415, then it is not clear how a former employee is treated for purposes of IRC §401(a)(4) if the actual payments occur in the plan year following the plan year in which employment terminated and the individual receives a benefit accrual (including an elective deferral) on such amount. Treating these individuals as former employees for purposes of IRC §401(a)(4) would create an administrative burden and increase administrative costs to employers.

ASPPA recommends thatif Post-severance Compensation is paid in a plan year following the limitation year in which employment terminated and the former employee receives benefits on such compensation, then for purposes of IRC §401(a)(4), then the individual should be treated as having terminated employment with less than 500 hours of service in the plan year in which the final payment is received.

6. The Post-severance Period Should Be Expanded for Governmental Employers

The 2½ month period during which certain payments are treated as Post-severance Compensation for purposes of IRC §415 may not always be sufficient time for some smaller governmental employers to make payouts of items such as unused sick and vacation pay. Governments are not subject to nondiscrimination testing issues, tax deduction timing requirements or Form 5500 filings, so the time period for the inclusion of Post-severance Compensation in IRC §415 compensation could be more flexible than might be possible in the private sector.

ASPPA recommends that government plan sponsors be permitted to continue to count Post-severance Compensation as compensation for purposes of IRC §415 up to the end of the plan year following the year of severance of employment provided that the Post-severance Compensation commences within 2½ months after severance of employment.

C. The IRC §415(b) Dollar Limit for Distributions Prior to Age 62 Should Not be Reduced Based on Increasing Age or Service

Proposed Regulation §1.415(b)-1(d) sets forth the methodology used to reduce the IRC §415(b) defined benefit dollar limit for distributions made prior to age 62. This reduction is generally determined by using the applicable mortality table and an interest rate that is the greater of 5% or the rate specified in the plan.

The Proposed Regulations provide examples on the application of the rule. However, Proposed Regulation §1.415(b)-1(d)(6) Examples 1 and 2 highlight an unusual situation where, through plan design, the plan interest rate appears to vary based on a participant's service. Under Example 2, there is a subsidized early retirement benefit at age 62 for individuals who have 30 years of service and do not commence benefits until age 62 or later. However, the subsidy is lost if an individual with 30 years of service elects to receive benefits prior to age 62. In order to determine the plan interest rate for purposes of calculating the reduction in the IRC §415(b) dollar limit, the fully subsidized benefit at 62 is compared to the unsubsidized benefit at age 60. If the participant did not have 30 years of service, this determination would be made by comparing the unsubsidized benefit at age 62 with the unsubsidized benefit at age 60, resulting in a larger IRC §415(b) dollar limit.

A reduction in the IRC §415(b) dollar limit resulting from an increase in a participant's service seems to be counterintuitive, inequitable and inconsistent with the purposes of IRC §415. IRC §415(b)(2)(C) specifically authorizes the Secretary of the Treasury to issue regulations addressing the adjustment of the limit for distributions made prior to age 62. It would therefore be permissible and appropriate for the Treasury to include a provision in the final regulations that would prevent the unusual result exemplified in the Proposed Regulations.

ASPPA recommends that the final regulation be modified to provide that in applying the adjustments to the IRC §415(b) dollar limit for distributions made prior to age 62, that there be no reduction in the limit solely because of an increase in an individual's age or service. This would be consistent with IRC §411(b)(1)(G) (which provides that an accrued benefit may not be decreased on account of increasing age or service) and would eliminate the inequitable result of the current rule.

D. Time of Application of Cost-of-Living Increase in the DB Dollar Limit Should Be Clarified

The defined benefit plan dollar limitation is adjusted annually for cost-of-living increases. Proposed Regulation §1.415(d)-1(a)(3) indicates that the cost-of-living increase is to apply to the calendar year and is effective for limitation years ending in the calendar year. However, the last sentence of Proposed Regulation §1.415(d)-1(a)(3) states that benefit payments and accrued benefits for a limitation year cannot exceed the applicable dollar limit (as in effect prior to the January 1 adjustment) prior to January 1. The application of this "January 1 rule" is not clear.

For example, if the 2006 defined benefit limit is increased to $175,000 (over the 2005 limit of $170,000) and the limitation year is July 1, 2005, to June 30, 2006, the $175,000 increased limit is the limit for the 05/06 limitation year. Under the January 1 rule, despite the increase for the 05/06 limitation year, there cannot be an accrual of benefit or a benefit payment based upon the $175,000prior to January 1, 2006.

Where the plan year ends prior to July 1 and requires 1,000 hours for benefit accrual, there is a potential conflict between the increase for the limitation year and the benefit that would be accrued. If termination of employment occurs after the accrual of benefits for the year, does this individual miss out on the last COLA increase?

For example, assume a plan year and limitation year of February 1, 2005, to January 31, 2006. The plan provides for the accrual of benefits after completion of 1,000 hours of service in the plan year. The IRC §415 maximum dollar limit for 2006 is increased from $170,000 to $175,000. This increase is effective for the plan year beginning February 1, 2005, and ending January 31, 2006. Joe terminates employment July 15, 2005, after completing 1000 hours of service. He wants to start his payments in October 2005. Is his benefit based upon the $170,000 limit or the $175,000 limit? If based on the $170,000 limit, can his October-December payments be based upon $170,000 and effective January 1, 2006, be based upon the $175,000 limit?

The application of adjusting payments after benefits have commenced as defined in Proposed Regulation §1.415(d)-1(a)(4)(iii) and (iv) relate to making adjustments where increases occur for subsequent limitation years. But, in the example above, the increase occurred for the limitation year for which the increase was already provided, but due to the January 1 rule, could not have accrued.

Also, for funding purposes under IRC §404(j), it is not clear when the increased limit should be recognized for non-calendar year plans.

For example, assume the 2006 IRC §415(b) dollar limit is increased to $175,000 from the 2005 limit of $170,000. The plan year and limitation year are December 1, 2005 to November 30, 2006. The valuation date is December 1, 2005. In light of the language in Proposed Regulation §1.415(d)-1(a)(3), it is not clear whether it is permissible under IRC §404(j) to fund towards a $175,000 annual pension.

ASPPA recommends that application of the January 1 rule for cost-of-living increases in Proposed Regulation §1.415(d)-1(a)(3) be clarified to address the

application to benefits and funding in the situations described above.

E. Existing Rule for the Correction of Excess Annual Additions Should Be Retained

Treasury Regulation §1.415-6(b)(6) sets forth certain methods of correcting plans' excess annual additions. The Proposed Regulations have deleted those rules. It is common to have occasional violations of the 415 limits, particularly in IRC 401(k) plans. Having a simple correction, allowed under the regulations and therefore includable in plan documents, eases the administration and costs of operating a plan. Moving this limited correction rule to EPCRS would unnecessarily burden plan sponsors, as well as the Service's EPCRS group. Other plan qualification regulations contain limited correction rules [*e.g.*, regulations under IRC §§401(a)(4), 401(a)(26)] that have not been "moved" to EPCRS and it is not clear why the IRC §415 correction rules should be treated any differently.

ASPPA recommends that the correction provisions for a failure of the IRC §415 annual additions limit be added back to the final IRC §415 regulations and not require correction under EPCRS.

F. Payments Made on Behalf of Individuals on Military Leave Should Be an Optional Exclusion from 415 Compensation

The Proposed Regulations provide that payments made on behalf of an individual who is on military leave be included in the definition of IRC §415 compensation. ASPPA recognizes the importance of providing for individuals on military leave and supports the protections provided under USERRA. ASPPA also supports employers that wish to provide continuation payments in excess of the amounts required to provided under USERRA (*i.e.,* differential pay). Unfortunately, the provision in the Proposed Regulation may actually discourage employers from providing differential pay. If differential pay is required to be included in IRC §415 compensation, then the cost of providing such pay would increase and this may dissuade some employers from providing the additional pay.

ASPPA recommends that differential pay be included in IRC §415 compensation at the election of the employer.

G. Guidance Is Needed for Service Credit Purchases Under IRC §415(n)

Although there has been pending legislation in recent years that would permit the purchase of "air-time" [*e.g.,* credit that is not attributable to prior service with the employer or which does not meet the requirements of IRC 415(n)(3)(A)] in a governmental defined benefit plan with transfers from 457 or 403(b) plans, it would be helpful if the IRS would clarify whether "air-time" in a governmental defined benefit plan is an acceptable service credit purchase with a transfer from 457 and 403(b) plans. Many 403(b) and 457 plan administrators and providers are facing additional pressure from plan sponsors and participants to transfer funds from these plans to governmental defined benefit plans to purchase "air time." Some state governments have apparently permitted the purchase of "air-time" in their defined benefit plans for a number of years.

The Proposed Regulations changed the wording in IRC §457 final regulations concerning the purchase of permissive service credits under IRC §415(n)(3)(A). The IRC §457 final regulations stated that 457 in-service transfers could be used to purchase past service credit in a governmental defined benefit plan. The Proposed Regulations have removed the word "past." It is not clear whether this removal was made merely to be consistent with the 457 statutory language (which does not use the word "past"). The 403(b) proposed regulations do not use the term past service credit, but merely refer to service credit purchases that meet the requirements of IRC §415(n)(3)(A). There is some concern that sponsors and participants might believe this change in the Proposed Regulation signals IRS and Treasury approval for "air-time" purchases.

ASPPA recommends that, pending any legislative changes, the IRS provide guidance explaining the IRS's position on "air-time" purchases.

H. Timing of Contributions to Plans of Tax-Exempt Employers Should Be Based on the Fiscal Year

The Proposed Regulations provide a special timing rule for determining when tax-exempt employer (including governmental employer) contributions are treated as annual additions for purposes of IRC §415. The Proposed Regulation reference "taxable year," which may not be applicable to such entities.

ASPPA recommends that the reference to "taxable year" in Proposed Regulation §1.415(c)-1(b)(6)(i)(B) for tax-exempt employers be replaced with "fiscal year" or otherwise define "taxable year" as in Treas. Reg. §48.6420-1(c) [calendar or fiscal year on the basis of which it regularly keeps its books, rather than IRC §7701(a)(23), for governmental units and tax-exempt organizations].

I. Miscellaneous Clarifications and Corrections

ASPPA recommends the following additional clarifications and corrections:

- The reference in Proposed Regulation §1.415(a)-1(d)(3)(v)(D) to the annually increased compensation limits should not be to IRC §415(b)(1)(B), but to 401(a)(17)(B). There would be two replacements.
- Example 2 in Proposed Regulation §1.415(f)-1(k) should be clarified by adding "for participant N" after "Accordingly" in paragraph (ii).
- The example in Proposed Regulation §1.415(g)-1(b)(3)(iv)(C) has a typographical error. The excess annual addition should be $18,000, not $20,000.
- The rules in Proposed Regulation §1.415(g)-1(b)(3)(iii)(A), regarding the ability of an employer to choose which plan within a controlled group is disqualified for an IRC §415 failure, should be expanded to include plan groups maintained by employers in an affiliated service group under IRC §414(m).

These comments were prepared by ASPPA's IRS Subcommittee, Mark L. Lofgren, Esq., APM, Chair, 401(k) Subcommittee, Virginia Krieger Sutton, Chair, Defined Benefit Subcommittee, David Lipkin, MSPA, Chair, and Tax-Exempt and Government Plans Subcommittee, L. Joann Albrecht, CPC, QPA, Chair of the Government Affairs Committee. Please contact us if you have any comments or questions regarding the matters discussed above. Thank you for your consideration of these comments.

Sincerely,

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