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WORKING FOR AMERICA'S RETIREMENT



## Comments on Proposed Regulations Sections 1.415(a)-1 through 1.415(j)-1

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Department of the Treasury
Internal Revenue Service

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The American Society of Pension Professionals and Actuaries (ASPPA) appreciates this opportunity to comment on the proposed amendments to the regulations under Internal Revenue Code (IRC) §415 issued by the Treasury and the Internal Revenue Service (the Service) on May 31, 2005 (Proposed Regulations). ASPPA's comments will be set forth in two separate documents. This document addresses three issues of major concern—the application of 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 three years of compensation; and the effective date of the regulations. ASPPA will soon submit a separate document that will address various other areas of concern.

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 over 5,500 actuaries, plan administrators, consultants, 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 Treasury and the Service for their efforts to update the 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. As you know, the Proposed Regulations include certain interpretations of the IRC §415 rules contrary to the current understanding of pension professionals. For the past 30 years, pension practitioners, the Treasury, and the Service have understood these rules to work in a certain way. Changing them now without a directive from Congress would be unfair to both plan sponsors and practitioners who have been relying on such guidance for these many years. Further, the proposed new rules likely will discourage the formation of new defined benefit plans and the continued maintenance of existing plans. This certainly would be undesirable from a retirement policy standpoint.

**Summary of Issues**

- The Proposed Regulations would change the long-established interpretation of IRC §415 by applying the IRC §401(a)(17) limit to the compensation taken into account in calculating a participant's maximum annual benefit or annual addition. The proposed treatment would be inconsistent with the statutory authority and existing regulations under IRC §401(a)(17) and would result in disproportionate harm to older workers. Therefore, ASPPA recommends that the new final regulations return to the prior treatment of compensation as provided in current guidance.
- The Proposed Regulations would change the currently accepted understanding (which has applied consistently for the past 30 years) that periods of pre-participation service may be considered in calculating the high three-year compensation average for participants in defined benefits plans. Since this change is not consistent with Congressional intent and likely will discourage the formation of new pension plans,

ASPPA believes that this proposed rule should be eliminated in the final regulations. At a minimum, ASPPA recommends that prior years of service treated as benefit service under a plan, as permitted under the IRC §401(a)(4) rules, be treated as years of active participation for purposes of IRC §415.

- The Proposed Regulations provide a grandfather rule to protect benefits accrued under a plan in existence as of May 31, 2005, provided the plan's benefit formula is not changed before the final regulations become effective. This essentially would result in retroactive application of major unanticipated changes, contrary to the usual manner of implementing new rules in non-abusive circumstances. In addition, the uncertainty regarding the content of the final regulations and the lack of any grandfather protection for benefits accruing in 2005 and 2006 under new or amended plans will have a chilling effect on the establishment of new plans, as well as on the amendment of existing plans. Because the proposed changes described herein are contrary to longstanding existing guidance and were not formulated as a response to any position taken by taxpayers perceived by the Treasury and the Service to be abusive, the grandfather protection should be extended to all benefits accrued as of the date immediately prior to the general effective date of the final regulations.

**Discussion of Issues**

**A. Eliminate Application of IRC §401(a)(17) Compensation Limit**

IRC §415 provides limits on the amount of benefits payable annually to a participant under a defined benefit plan and the amount permitted to be contributed annually to a participant's defined contribution plan account. These limits have been commonly understood by practitioners to apply after a participant's accrued benefit is determined, as opposed to being part of the accrued benefit computation. IRC §401(a)(17), on the other hand, limits the amount of compensation permitted to be considered in determining a participant's accrued benefit, and also applies for purposes of certain nondiscrimination rules. Until now, there was no question that in computing the limit on annual benefits or annual additions under IRC §415, a participant's compensation should not be limited by the IRC §401(a)(17) maximum.

The Proposed Regulations would change the long-established interpretation of IRC §415 by subjecting the compensation taken into account in determining a participant's maximum annual benefit to the IRC §401(a)(17) limit. As proposed, IRC §1.415(c)-2(f) would read as follows:

*Interaction with* IRC §*401(a)(17)*. Because a plan may not base allocations (in the case of a defined contribution plan) or benefit accruals (in the case of a defined benefit plan) on compensation in excess of the limitation under IRC §401 (a)(17), a plan's definition of compensation for a limitation year that is used for purposes of applying the limitations of IRC §415 is not permitted to reflect compensation for a plan year that is in excess of the limitation under IRC §401(a) (17) that applies to that plan year.

The Preamble uses similar language to explain the proposed change:

Because a plan may not base benefit accruals on compensation in excess of the limitation under IRC §401(a)(17), a plan's definition of compensation used for purposes of applying the limitations of IRC §415 is not permitted to reflect compensation in excess of the limitation under IRC §401(a)(17).

As set forth below, this interpretation is impractical, is contrary to most existing authority, and disproportionately hurts older workers.

**1. Statute and Prior Guidance**

Until the Proposed Regulations were issued, the IRC §401(a)(17) limit had never been applied in the IRC §415 context. The relevant statutory language, legislative history, current regulations, and existing IRS guidance support, directly and indirectly, that the compensation used in applying the IRC §415 limits is not restricted by the IRC §401(a)(17) limit.

**a. Congressional Intent**

There is no direct statutory authority linking IRC §§401(a)(17) and 415; neither statutory provision makes mention of the other. In fact, as explained in the legislative history of IRC §401(a)(17), the intent was that the IRC §401(a)(17) limit not apply in the IRC §415 context. "In addition, for purposes of the percentage of compensation limit under the overall limits on contributions and benefits (IRC §415), all compensation (including that in excess of $200,000) is taken into account." Staff of J. Comm. on Tax'n, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, JCS-38-82, at 318 (1982). Furthermore, nothing in the legislative history of statutory changes to IRC §415 indicates application of IRC §401(a)(17) [although IRC §401(a)(17) was applicable only in limited circumstances — first to self-employed and owner employees, then to top-heavy plans — until 1989].

The purpose of the IRC §401(a)(17) compensation limit, as stated in legislative history, is to provide reinforcement to the nondiscrimination provisions; it is not intended as a maximum benefit limit.

The purpose of the limitation is to ensure that reductions in the maximum contributions or benefits do not reduce the contributions or benefits of low- and middle-income employees. Congress concluded it would be inconsistent with this intent to permit plans to define compensation in such a manner that the $200,000 limit has little effect on highly compensated employees, while adversely affecting low- and middle-income employees.

Staff of J. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, JCS-10-87, at 740 (1987). This purpose is further explained by the Senate Budget Committee's comments under OBRA 93:

The limit on compensation taken into account under a qualified pension plan serves as a useful backstop to the nondiscrimination requirements applicable to qualified plans. By limiting the compensation taken into account under a plan, an employer is deemed to be providing greater benefits as a percentage of pay to an employee with compensation in excess of the cap than would be the case if all of the employee's compensation were taken into account. As a result, under the nondiscrimination rules rank-and-file employees will be entitled to benefits that are a larger percentage of their pay. The committee believes that the goal of reducing the extent to which employersdiscriminate in the provision of pension benefits in favor of highly compensated employees can be better served by reducing further the compensation taken into account under qualified plans.

S. Prt. 103-36, at 254 (1993).

In 1982, IRC §415 was amended to specifically provide for actuarial adjustment of the dollar limit for commencement after age 65. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, IRC § 235(e)(3) (TEFRA 82). Actuarial adjustment of the dollar limit under IRC §415 is necessary to permit full actuarial adjustment of a participant's accrued benefit for post-normal retirement age commencement. Limiting the compensation taken into account under IRC §415 to the IRC §401(a)(17) amount, an amount that is not adjusted for age, would negate the actuarial adjustment of the IRC §415 dollar limit for some individuals with high compensation. There is no evidence that Congress intended for the actuarial adjustment of IRC §415 to be cut off for any participants.

The difference in the dollar amounts specified in IRC §§415 and 401(a)(17) also lends support for their independent application. The two amounts have always differed and numerous changes have been made to each dollar amount over the years. At some point, Congress could have established the IRC §415 dollar limit as the IRC §401(a)(17) limit, or vice versa. Or, Congress could have stated that the compensation taken into account under IRC §415 shall be limited by IRC §401(a)(17). In fact, the definition of compensation under IRC §415(c)(3) was changed in 1982, without any evidence of application of IRC §401(a)(17). Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, IRC §253(a) (TEFRA 82). That Congress never acted to coordinate the two provisions demonstrates an intent that they should not be linked.

**b. Regulations**

Until now, the Treasury and the Service have followed this intent, having never before applied IRC §401(a)(17) to IRC §415. When Congress expanded the reach of IRC §401(a)(17) in 1986 (effective for 1989), there was no additional guidance issued to make IRC §401(a)(17) applicable in the IRC §415 context. The "fresh start" rules for determining benefit accruals after the wide-spread implementation of the $200,000 compensation limit for 1989, and the subsequent reduction of the limit to $150,000 for 1994, were not extended to IRC §415. Treas. Reg. §1.401(a)(17)-1(e). The fresh start rules under IRC §401(a)(17), however, were coordinated with fresh start rules under IRC §401(a)(4). Id.

In this regard, the regulations under IRC §401(a)(17) note the link between the IRC §401(a)(17) limit and the nondiscrimination rules, while neglecting to express any link between the IRC §415 benefit limit and the compensation limit:

This limit [IRC §401(a)(17)] applies to a qualified plan in two ways. First, a plan may not base allocations, in the case of a defined contribution plan, or benefit accruals, in the case of a defined benefit plan, on compensation in excess of the annual compensation limit. Second, the amount of an employee's annual compensation that may be taken into account in applying certain specified nondiscrimination rules under the Internal Revenue Code is subject to the annual compensation limit.

Treas. Reg. §1.401(a)(17)-1(a)(1). *See also* T.D. 8547, 1994-2 C.B. 50 [preamble to IRC §401(a)(17) regulations], 55 Fed. Reg. 19,947 (May 14, 1990) [preamble to proposed 401(a)(17) regulations] and 58 Fed. Reg. 69,302 (Dec. 30, 1993) [preamble to proposed 401(a)(17) regulations], all of which mimic the quoted language above.

The regulations provide further detail on the two stated purposes of the IRC §401(a)(17) limit, without mentioning IRC §415. ASPPA believes that the first of the two purposes, determining benefit accruals, should not be interpreted to include the IRC §415 limit, as IRC §415 is used to *limit* benefits, not *determine ongoing benefit accruals*. Furthermore, if the first purpose is meant to include more than merely the determination of benefit accruals under the plan's formula, it would seem that identifying the second purpose, certain nondiscrimination rules, would not be necessary. In other words, by specifically referencing nondiscrimination rules, the regulations apparently recognize that those rules fall outside the scope of "determining" accruals. The IRC §415 limit likewise falls outside the scope of determining benefit accruals, but was not specifically referenced as being impacted by IRC §401(a)(17).

For defined benefit plans, the effect of the proposed interpretation is that IRC §401(a)(17) would be applied twice — once when an accrual is credited to a participant and again at distribution of the benefit. For example, in a plan with a compensation-based formula, a participant's accrued benefit must be calculated based only on compensation under the IRC §401(a)(17) limit. Treas. Reg. §1.401(a)(17)-1(b). For a participant whose accrued benefit is so limited, his annual benefit should not be further limited by a second application of the IRC §401(a)(17) limit. Instead, ASPPA recommends that the IRC §401(a)(17) limit apply only at the time the accruals are credited as currently anticipated under the IRC §401(a)(17) regulations, after which the participant's benefit would be permitted to grow up to the IRC §415 limits [without applying the IRC §401(a)(17) limit a second time].

**c. Other Guidance**

The following two excerpts from the IRS Examination Guidelines clearly illustrate the Service's and practitioners' understanding of the relationship between IRC §§415 and 401(a)(17):

You should note that for purposes of applying the percentage of compensation limitations of IRC §415, compensation is not limited by the IRC §401(a)(17) compensation limit. However, the plan must satisfy the IRC §401(a)(17) compensation limit. Therefore, the plan provisions for determining contributions or allocations may not be based upon compensation in excess of the IRC §401(a)(17) limit.

I.R.S. Announcement 95-33, I.R.B. 1995-19 (Apr. 17, 1995).

It is important to note that the percentage of compensation limitations of IRC §§ 415(b) and IRC 415(c) are based upon the actual IRC §415(c)(3) compensation, without regard to the IRC §401(a)(17) limit. However, the benefits and contributions to which the IRC §415 limitations are applied cannot be based on compensation in excess of the IRC §401(a)(17) compensation limit.

I.R.S. Announcement 95-99, I.R.B. 1995-48 (Nov. 22, 1995).

**2. Practical Considerations**

In a practical sense, applying the IRC §401(a)(17) limit to compensation under IRC §415 is inappropriate because, in the defined benefit plan context, the application would affect a small subset of participants and produce odd results for those affected. In addition, for defined contribution plans, applying IRC §401 (a)(17) would have no effect due to the much lower defined contribution dollar limit discussed below.

**a. Defined Benefit Plans**

Because the IRC §415 defined benefit dollar limit is adjusted for age, the older the participant, the more likely it is that his or her benefit will be reduced due to the application of IRC §401(a)(17). For a participant commencing benefits after age 65, the IRC §415 dollar limit increases. With a higher dollar limit, there is a greater likelihood that the participant's average compensation [as limited by IRC §401(a)(17)] would be lower and thus ultimately would control the IRC §415 limit for that individual. This heightened effect on older workers is undesirable from a policy standpoint, as discussed later.

Furthermore, applying the two limits in combination generally produces odd results. The IRC §415 dollar limit for participants commencing benefits at or before age 65 (currently $170,000) would always be lower than the IRC §401(a)(17) limit (currently $210,000). However, because the defined benefit plan compensation limitation uses a three-year average, the IRC §401(a)(17) compensation limit would impact the "lesser of" test in IRC §415 only if the participant had wide variation in compensation during the three years considered, which would be unusual for the typical corporate employee. Small business owners, on the other hand, are much more likely to have wide variation in compensation than employees of large corporations. A corporate employee might earn $175,000 per year over a three-year period, even if the corporate profits fluctuated during this time. In contrast, a small business owner might earn $250,000 in one year, $125,000 in the next and $150,000 in the third year. Although the total compensation over the three-year period is identical for both individuals, the small business owner's average compensation, as limited by IRC §401(a)(17), would be only $161,667 (($210,000+$125,000+$150,000)/3) as compared to the corporate employee, whose average compensation for the same period would be $175,000. Thus, two similarly compensated individuals, one working for a large corporation and the other owning a small business, could end up with completely different benefit limits under IRC §415.

**b. Defined Contribution Plans**

For defined contribution plans, the application of IRC §401(a)(17) to the limit on annual additions would be meaningless. The IRC §415 limit for defined contribution plans is the lesser of $40,000 (adjusted for cost of living increases) or 100% of compensation. The compensation limit under IRC §401(a)(17) would never come into play since the dollar limit under IRC §415 (currently $42,000) would always be lower for a participant whose compensation is limited by IRC §401(a)(17). This discrepancy is further evidence that there should be no relation between the IRC §401(a)(17) and IRC §415 limits. The Service's proposed position would make the IRC §401(a)(17) limit applicable to the IRC §415 limits solely for defined benefit plans, since it would have no application in the defined contribution plan context. But, since the same rules apply to the definition of compensation for both defined contribution and defined benefit plan purposes, it would be odd for the proposed statutory construction to impact only one type of plan without a specific requirement in the statute.

**3. Policy Considerations**

As mentioned earlier, the application of IRC §401(a)(17) to IRC §415 negatively impacts older participants who work beyond normal retirement age. As the Preamble to the Proposed Regulations notes, the most profound impact of this new restriction occurs with a participant old enough so that the compensation limit overrides the dollar limit. (The latter is actuarially adjusted for ages over 65, while the former is not.) This would happen for a participant who is around age

68 or older, although the Proposed Regulations preamble illustrates the issue using a participant at age 75:

[F]or example, where a participant commences receiving benefits in 2005 at age 75 (so that the adjusted dollar limitation could be as high as $379,783), and the participant had compensation in excess of the applicable IRC §401(a)(17) limit for 2002, 2003, and 2004, the participant's benefit under the plan is limited by the average compensation for his highest three years as limited by IRC §401(a)(17) (*i.e.*, $201,667, or the average of $200,000, $200,000, and $205,000).

Proposed Regulations, 70 Fed. Reg. 31,214, 31,217. ASPPA believes that an interpretation that negatively impacts older workers almost exclusively is unwise.

The actuarial increase for commencement after normal retirement age is essential to maintaining basic fairness between the plan and its participants. With no actuarial increase available after a certain age [our preliminary tests indicate an age 68 "crossover point," at which the actuarial increase of the dollar limit is capped by the IRC §401(a)(17) compensation limit], the actuarial present value of the participant's benefit will steadily decrease over time. This will create very inefficient situations whereby, due to normal investment growth, the plan's assets start to rapidly exceed the liability for the (capped and eroding) IRC §415 limit. With liabilities declining and assets growing, the situation can easily degenerate into a hopelessly and permanently overfunded plan. The creation of overfunded plans, which will occur much more frequently under these Proposed Regulations, benefits no one — not plan sponsors, not participants, and not public policy. Further, this is inherently unfair to those who (for whatever reason) defer commencement of pension payments. Late retirement increases ought not be artificially capped by applying IRC §401(a)(17) compensation limits to the IRC §415 maximum benefit.

A related problem arises when considering the actuarial adjustment that occurs for a participant who does not work past normal retirement age but who defers commencement of his or her benefit beyond age 65. An annual benefit at age 65 that would fall under the IRC §415 limit [as limited by IRC §401(a)(17)] could exceed the IRC §415 limit if the participant commences at age 66, solely because the delay causes an actuarial adjustment to the normal retirement age benefit, without a corresponding adjustment to the IRC §415 compensation limit. Suppose a participant with an annual benefit of $165,000 at age 65 does not commence until age 66, at which point his annual benefit increases actuarially to $175,000. Suppose the participant's high three-year average compensation, as limited by IRC §401(a)(17), was $170,000. The IRC §415 dollar limit would increase for post-age 65 commencement, but the compensation limit would remain the same. As a result, the participant would not be entitled to the otherwise required actuarial increase for post-normal retirement age commencement. Thus, a mere one-year delay in commencement could have adverse consequences to the plan participant.

**4. Conclusion**

***ASPPA recommends*** that this proposed application of IRC §401(a)(17) be eliminated from the final regulations, as it serves little purpose, outside of reducing the benefits otherwise payable under a defined benefit plan to an older worker who has continued to work past age 65. The Proposed Regulations directly conflict with most existing authority on the matter and produce results that were not intended by Congress. The final regulations should conform to the existing IRC §415 guidance in this regard.

- **Allow Inclusion of Pre-participation Service in High Three-Year Average**

The IRC §415 limit on annual benefits payable under a defined benefit plan takes into account a participant's highest three years of compensation. Prior guidance has assumed that these three years could include any year in which the participant received compensation from the employer, regardless of whether the participant was participating in the plan in that year.

Proposed Regulation §1.415(b)-1(a)(5)(i) would change the currently accepted understanding of how the high three-year limit applies. The proposed language reads: "the period of a participant's high three years of service is the period of three consecutive calendar years during which the employee was an active participant in the plan and had the greatest aggregate compensation . . . from the employer." Since at least 1980, it has been acceptable to consider any three-year period of service, whether or not the individual was an active participant during the period. See Treas. Reg. §1.415-3(a)(3) (1980); Rev. Rul. 75-481, 1975-2 C.B. 188. ASPPA believes the existing understanding of this rule better reflects Congressional intent and generally is a more reasonable approach. Alternatively, as explained further below, a participant should be deemed to have been a participant for any year for which he received a benefit accrual under the plan to the extent permitted under the nondiscrimination rules of IRC §401(a)(4).

**1. Statute and Prior Guidance**

**a. Congressional Intent**

IRC §415(b)(3) provides that: "a participant's high three years shall be the period of consecutive calendar years (not more than three) during which the participant both was an active participant in the plan and had the greatest aggregate compensation from the employer." This provision has remained unchanged since enactment of ERISA. The legislative history of ERISA, however, conflicts with the statutory language regarding the high three-year average, and actually supports the current regulations. In particular, the conference report states that "[u]nder the conference substitute, in general, the highest annual benefit which can be paid . . . out of a defined benefit plan to a participant is not to exceed the lesser of (a) $75,000, or (b) 100 percent of the participant's average compensation in his high three years of employment." H.R. Conf. Rep. No. 93-1280, at 344-48 (1974) (emphasis added).

Prior changes to the 10-year phase-in of the IRC §415 limits supports Congress' intention that IRC §415(b)(3) be read more expansively to include compensation before active participation begins. In 1986, Congress amended IRC §415(b)(5) to change the 10-year phase-in rule from "years of service" to "years of participation" for the dollar limit only, specifically continuing to apply "years of service" to the compensation limit phase-in. Tax Reform Act of 1986, Pub. L. No. 99-514, §1106(f). It would appear that Congress recognized that the maximum benefit under IRC §415(b)(1)(B) could be based on a three-year average that included pre-participation compensation. For example, for a participant with five years of service when a plan is established, the IRC §415 limit as of the end of the first plan year is the lesser of 60% of the high three-year compensation average (six years of service divided by 10) or 10% of the dollar limit (one year of participation divided by 10). If pre-participation years of service are relevant in determining whether an individual is entitled to the full compensation limit, compensation for those pre-participation years of service arguably should be eligible for inclusion in the three-year average.

**b. Regulations**

Consistent with the ERISA Conference Report, the current regulations under IRC §415 provide that "a participant's high three years of service is the period of three consecutive calendar years (or, the actual number of consecutive years of employment for those employees who are employed for less than three consecutive years with the employer) . . . during which the employee had the greatest aggregate compensation . . . from the employer." Treas. Reg. §1.415-3 (a)(3). The regulations contain no requirement of actual plan participation during the period. The Preamble to the regulations proposed in 1980 references "years of service with the employer," rather than "years of participation":

Under the regulations, a participant's projected annual benefit [may not] . . . exceed the lesser of $75,000 (subject to cost-of-living increases) or 100 percent of the participant's average compensation for his high three years of service with the employer. The regulations provide that a participant's high three years of service is the period of three consecutive calendar years during which the employee had the greatest aggregate compensation from the employer.

45 Fed. Reg. 5754, 5755 (Jan. 24, 1980) (emphasis added). Furthermore, the Preamble to the final regulations discusses the special rule for short service employees, in terms of "employment" for less than three years instead of "participation" for less than three years:

Finally, in determining a participant's compensation for the high three years of service, the final regulations provide a special rule where the participant is employed for less than three consecutive years with the employer and make it clear that a plan may use any 12-month period instead of the calendar year, provided that it is uniformly and consistently applied.

T.D. 7748, 1981-1 C.B. 259 (emphasis added).

**c. Other Guidance**

Before the current regulations were issued, Revenue Ruling 75-481 provided interim guidance on IRC §415. "[T]he projected annual benefit of a participant may not, at any time within the limitation year, exceed the lesser of (1) $75,000, or (2) 100 percent of the participant's average compensation for his high three consecutive years of service." This is evidence that from the very inception of IRC §415, the Service interpreted Congressional intent to treat all of an employee's years of service as relevant for the compensation average.

Finally, we note that the Defined Benefit Listing of Required Modifications and Information Package (LRM, Feb. 2000) defines "highest average compensation" as "the average compensation for the three consecutive years of service with the employer that produces the highest average."

**2. Policy Considerations**

ASPPA believes that the proposed change not only would be unfair to employee-owners who participate in a pension plan but would also serve to discourage the formation of new defined benefit plans. For partners and proprietors, it is not uncommon for the highest paid three years to occur before commencement of plan participation. There can be a profound change in compensation when the employee-owner of a corporation establishes a plan, because the cost of funding the plan reduces the profits of the business. There is no logical basis for ignoring these years of higher compensation in the IRC §415 limit. In fact, ignoring earlier years of service for owner-employees could discourage the formation of new pension plans.

The impact of the proposed changes on the establishment of plans by small employers can be illustrated by the following simple case study:

Consider a sole proprietor who begins operations in 1992 at age 40. From 1992 through 2002, he is building his business, taking compensation in the $50,000 range, and plowing everything else back into the business. He has been contributing to a profit sharing plan during that time in order to attract his employees. Beginning in 2002, his business really begins to take off, and his compensation increases to $200,000+ as the funds are not needed to build the business and are available to him as disposable income. He is concerned about retirement, and is considering instituting a defined benefit pension plan for 2005. Assume that his earnings from self employment (before pension but after other expenses, including one-half of the self-employment tax) have been $200,000 each year since 2002, and will continue at that level until age 62.

Plan Benefits and Cost Under Existing Regulations

Assume the proprietor establishes a defined benefit plan in 2005 based on the existing regulations. Based on compensation from 2002 to 2004 (pre-participation compensation), the proprietor would have average compensation of $200,000 for IRC §415 purposes. If the plan has an age 62 normal retirement age, the proprietor would have 13 years of service and 10 years of plan participation at normal retirement.

Assuming the proprietor wishes to provide as large a benefit as possible, a plan could be established that provides a benefit accrual equal to 6.55% of compensation for each year of service. At normal retirement age the proprietor's benefit would be the maximum IRC §415 benefit, $170,000 (6.55% x 13 years x $200,000). Assume the proprietor wants the plan to provide the same level of benefit to all employees of the business. Thus, the plan would provide a retirement pension of more than 6.50% of pay for each year of service to the employees. This is a generous, and expensive, benefit in the current era of deferral-only 401(k) plans.

The required contribution to fund the proprietor's portion of the plan, using conservative assumptions, would be $166,000 per year. The total contribution during the proprietor's career would be $1,660,000.

Plan Benefits and Cost Under Proposed Regulations

Under the Proposed Regulations, the proprietor's compensation for years prior to the establishment of the plan cannot be considered. This means that the proprietor's income for 2005 and later must be used both to establish a baseline compensation and to fund the plan benefits.

A likely design would be a plan that provides 10% of pay for each year of plan participation, to a maximum of 100% after 10 years.

As compared with the benefit design under the existing regulations, this design would reduce the contribution to fund the proprietor's benefit to $99,000 per year for 10 years and would reduce the proprietor's average compensation and annual pension to $101,000. This is a 40% reduction in the deduction and retirement benefits for the proprietor from the design under the existing rules. At the same time, the cost of benefits for employees would skyrocket. For a new employee the benefit being earned each year (and the associated cost) would increase by 52%, from a 6.55% of pay pension to a 10% of pay pension.

Thus, the exclusion of pre-participation compensation, in this typical example, would reduce the proprietor's benefit by 40% and, in order to receive this lower benefit, the proprietor would have to increase staff costs by more than 50%. Given the economic impact of this change in the rules, it is likely that many small employers will choose not to implement a defined benefit plan, resulting in lower coverage rates and smaller benefits for employees.

The motivation for switching to years of participation in this context is unclear. If the change is based on a concern that individuals are accruing benefits at a disproportionate level later in their careers, that concern is addressed by the 10-year phase-in rule for short-service employees. IRC §415(b)(5). As explained in the legislative history of ERISA, with respect to the phase-in, "[t]he conference substitute also contains technical rules to prevent an individual from obtaining unintended high benefit accruals late in his career merely by establishing a 'token plan' early in his career." H.R. Conf. Rep. No. 93-1280, at 334 (1974). Although at first the phase-in was based solely on "years of service," both with respect to the dollar limit and the compensation limit, the restriction as applied to the dollar limit was changed from years of service to years of participation by the Tax Reform Act of 1986. The Joint Committee describes the reason for this change:

Congress was concerned that the rule requiring reduced limits on benefits payable to participants with fewer than 10 years of service was not effectively limiting benefits for highly paid employees with short periods of plan participation. Congress was aware that some employers were able to arrange the time for establishment of a defined benefit pension plan . . . to coincide with the projected retirement of one or more of the employer's highly compensated employees. The effect of this delay was to avoid providing a comparable level of benefits to other employees who retired before the highly compensated employees. Further, if the employer ceased to do business after the retirement of a highly paid employee, then other employees might have been denied the opportunity to earn comparable pension benefits . . . Congress believed that the limits should be structured to encourage employers to establish plans earlier and to increase benefits sooner by providing that the dollar limit on annual benefits is phased in over a period of 10 years of participation (rather than service).

Staff of J. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, JCS-10-87, at 733 (1987). Because of the 10-year phase-in and the nondiscrimination provisions under IRC §401(a)(4), there is no need for the additional safe-guard provided in the Proposed Regulations. Also, the requirements of IRC §§416 and 401(a)(26) are designed to ensure that rank and file employees receive meaningful benefit accruals.

Alternatively, the Proposed Regulations could be revised to permit inclusion of pre-participation service in the compensation limit where the plan treats prior years of service as benefit service, as permitted under the IRC §401(a)(4) nondiscrimination rules. Under those rules, participation may be extended retroactively to a prior period of service. At a minimum, where prior years of service are counted under a plan for accrual purposes, those prior years of service should be treated as participation service for purposes of determining IRC §415 compensation. We note that the regulations under IRC §401(a)(4) contain a safe-harbor, under which past service credit is considered not to discriminate in favor of highly-compensated employees. In this safe-harbor, the period of past-service to be credited may not exceed the five years immediately preceding the year in which the plan provision that counts prior service is effective. Treas. Reg. §1.401(a)(4)-5(a)(3). A similar safe-harbor could be used in this context, with the five years prior to the start of actual participation being eligible for the high three-year average. However, ASPPA believes that in addition to this safe-harbor, the compensation for all periods of service for which accruals occur under plan terms should be eligible for consideration. The current rules under IRC §401(a)(4) will limit the ability to discriminate in this regard.

**3. Conclusion**

***ASPPA recommends*** that the Service return to its prior interpretation of the high three-year average in the final regulations. The exclusion of pre-participation service does not reflect the likely intent of Congress and diverges from three decades of consistent treatment. In addition, under the Proposed Regulations, the limit on annual benefits of owner-employees could be drastically reduced based on a skewed compensation average, which in turn could discourage the formation of new pension plans. At the very least, the final regulations should permit consideration of any period of service that is counted for accrual purposes, as permitted under IRC §401(a)(4), and could also include a safe-harbor similar to the regulatory five-year safe-harbor for past service credit.

**C. Effective Dates**

The Proposed Regulations provide that the final rules will be effective for limitation years beginning on or after January 1, 2007. The Proposed Regulations also include a "grandfather" provision that applies to defined benefit plans. Prop. Reg. §1.415(a)-1(g). Under this provision, the accrued benefit of a participant in a defined benefit plan will be treated as meeting the IRC §415 limit as of the effective date of the final regulations if the benefit is accrued pursuant to plan provisions that were adopted and effective before May 31, 2005, and the plan provisions meet the "statutory provisions, regulations, and other published guidance in effect on May 31, 2005." The Preamble provides that additional accruals after the effective date of the final regulations will be permitted only if a participant's pre- and post-effective date accruals, on an aggregated basis, meet the new IRC §415 rules.

Grandfather provisions usually are provided in order to protect the reasonable expectations of plan sponsors and plan participants. This is especially true when the government's interpretation of the Internal Revenue Code, as in these Proposed Regulations, has dramatically changed from the prior interpretation. At times when the Treasury and the Service have been faced with a transaction based on an aggressive interpretation of existing authority, they have retroactively applied the provisions of a final regulation – mainly in the case of listed transactions. The grandfather provision of these Proposed Regulations does not provide the sort of protection of expectations that would normally be allowed where the Treasury and the Service specifically permitted another interpretation of the statute in the past. In fact, this grandfather provision actually masks a retroactive effective date.

Basing the grandfather protection on plan provisions in effect on May 31, 2005, means that benefits provided by a defined benefit plan adopted after May 31, 2005, as well as benefits attributable to a post-May 31, 2005, amendment to an existing plan, will not be covered by the grandfather. As explained below, this will result in a virtual freeze on the establishment of new defined benefit plans after May 31, 2005, as well as on the amendment of plans in effect as of May 31, 2005, until the proposed rules are finalized. Any company that, despite the lack of guidance on the final IRC §415 rules, adopts a new plan, or amends the benefit formula of an existing plan, after May 31, 2005, will have to anticipate the content of the final regulations because benefits accrued in 2005 and 2006, although purportedly subject to existing guidance for 2005 and 2006, will become subject to the final regulations in 2007. This means that, in effect, the final regulations (in whatever form adopted) will be retroactively effective for post-May 31, 2005, accruals that are not protected by the grandfather.

This is unfair to plan sponsors and plan participants alike. The positions taken or to be taken during the pendency of the finalization of the IRC §415 regulations by plan sponsors in designing their plans are based on clearly articulated longstanding positions of the Treasury and the Service. Plans designed in good faith by following that clearly articulated guidance should not be subjected to a retroactive application of the final regulations and treatment in a manner tantamount to that as has been directed at those who engaged in listed transactions or other purportedly abusive practices. **ASPPA strongly recommends** that the effective date be changed so that plan benefits that were predicated on the regulations and other guidance that have been in effect for 30 years be maintained and protected.

**1. New Defined Benefit Plans**

It is doubtful that a company would implement a new defined benefit plan after May 31, 2005, and before the final regulations become effective, because of the uncertainty regarding this important limit on benefits. This is especially true for small companies, which commonly provide benefits up to the IRC §415 limit for the company's owner. These companies would not risk implementing a new plan without knowing what the final IRC §415 rules will be.

If a company were to implement a new plan despite this uncertainty, it risks implementing a plan that provides benefits greater than ultimately permitted under the final rules, requiring the benefit formula to be redesigned and participants informed of a reduction in benefits. Alternatively, the company might design the plan to provide less generous benefits than the company would otherwise provide, in order to avoid any potential problems with the new regulations. In either event, without the protection of the grandfather, the final regulations would apply to these benefits, thereby giving the final regulations retroactive effect, as early as May 31, 2005.

**2. Existing Defined Benefit Plans**

The May 31 date also creates a problem for existing plans. First, it appears that, in order for a plan to preserve its grandfathered status, neither its benefit formula nor any provision relating to the benefit formula may be changed after May 31, either to increase or decrease benefits. If such a change is made, the grandfather might continue to apply to pre-May 31 accruals even if it does not apply to post-May 31 accruals — it is unclear from the guidance how this would work. The result is that the new guidance interferes with a company's ability to design its retirement plan in a manner favorable to the company and its employees because, in light of the uncertainty regarding the final regulations, retaining the eligibility of all plan benefits for the grandfather will be crucial. This is only possible if a company foregoes its right to make changes to its plan from May 31, 2005, until the regulations are finalized. Plans should not be kept in this kind of limbo when there is existing uncontroversial guidance in place pending finalization of the new regulation.

There is also a problem relating to the relevant legal requirements for grandfathered plans. The proposed regulations state that the grandfather will protect only benefit accruals pursuant to plan provisions — apparently both IRC §415 and non-section 415 provisions — that meet the "statutory provisions, regulations, and other published guidance in effect on May 31, 2005." Therefore, the grandfather will be available only to a plan that meets the requirements of the Internal Revenue Code as in effect on May 31, 2005. The proposed regulations do not state the date on which this requirement must be satisfied. One could interpret this requirement as applying as of May 31, 2005. In contrast, one could interpret this requirement as applying as of the date immediately before the grandfather becomes effective, *i.e.*, the last day of the 2006 limitation year. Under this interpretation, the legal requirements in effect on May 31, 2005, would continue to apply until 2007. For example, the IRC §§415 and 401(a)(17) limits would not be increased in 2006 to reflect the annual COLAs.

**3. Proposed Approach to Grandfather**

A better approach would be to provide that all benefits accrued as of the date immediately before the first day of the limitation year beginning in 2007 would be subject to the grandfather, provided the plan met the legal requirements in effect as of such date. This approach would avoid the uncertainty regarding post-May 31, 2005, accruals and, for this reason, not have the chilling effect associated with the May 31, 2005, effective date date; this approach would not interfere with a company's ability to implement and modify its retirement plan before the regulations are finalized. In addition, this approach would be consistent with the manner in which other legal changes in legal limits have been implemented. For example, when the $150,000 limit on compensation under IRC §401(a)(17) was implemented in 1994, the "fresh-start date" was the day before the effective date of the change, not a date more than one year earlier.

Presumably, the reason for the May 31, 2005, date is to prevent companies from quickly implementing or modifying their plans to maximize benefits in anticipation of the new regulations. However, since the current IRC §415 rules that have applied for many years will continue to apply until the 2007 limitation year, the room for abuse is small and surely outweighed by the harm in permitting the uncertainty associated with the use of the May 31, 2005, date.

**4. Conclusion**

***ASPPA recommends*** that all benefits accrued as of the date immediately before the first day of the limitation year to which the final regulations apply be grandfathered, provided the plan met the legal requirements in effect as of such date.

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These comments were prepared by ASPPA's IRS subcommittee and DB subcommittee of the Government Affairs Committee, Mark L. Lofgren, APM, Chair, and David Lipkin, MSPA, Chair, and primarily authored by the Groom Law Group. Please contact us if you have any comments or questions regarding the matters discussed above. Thank you for consideration of these comments.

Sincerely,

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| Brian H. Graff, Esq. APM<br>Executive Director | Teresa T. Bloom, Esq., APM, Co-chair<br>Gov't Affairs Committee |
| Ilene H. Ferenczy, Esq., CPC, Co-chair<br>Gov't Affairs Committee | George J. Taylor, MSPA, Co-chair<br>Gov't Affairs Committee |
| Sal L. Tripodi, Esq., APM, Co-chair<br>Gov't Affairs Committee | Robert M. Richter, Esq., APM, Chair<br>Administrative Relations Committee |

*But see* Staff of J. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, JCS-10-87, at 732 (1987), describing existing law under IRC §401(a)(17): "This limit on includible compensation applied for purposes of determining (1) the dollar limits on contributions and benefits ( § 415), and (2) whether a plan met the nondiscrimination requirements [IRC §§ 401(a)(4) and 408(k)(3)]."

The Joint Committee also affirms: "The [401(a)(17)] limit applies under the Act, for most purposes, including the provisions relating to nondiscrimination requirements [*e.g.*, §§ 401(a)(4), 401(a)(5), 401(k)(3), 401(l), 401(m), 408(k), and 410(b)]." Id. at 740. Notably, IRC § 415 is not mentioned in that list of provisions.

When ERISA was enacted, the IRC § 401(a)(17) limit was $100,000 and the IRC § 415 dollar limit was $75,000. By 1982, the IRC § 415 limit had been indexed up to $136,425 and the compensation limit had been raised to $200,000. TEFRA 82 lowered the IRC § 415 limit to $90,000, while the compensation limit remained unchanged until 1994, when it was reduced to $150,000. Both limits were increased by EGTRRA for 2002, when the compensation limit returned to $200,000 and the IRC § 415 limit was increased to $160,000.

In the Preamble to the current IRC § 415 regulations, compensation for IRC § 415 purposes is discussed without addressing the IRC § 401(a)(17) limit. *See* T.D. 7748, 1981-1 C.B. 259 (preamble to final regulations) and 45 Fed. Reg. 5754 (Jan. 24, 1980) (preamble to proposed regulations).

But see H.R. Rep. No. 93-779, at 117 (1974), the House Report on which the Conference Report is based, referring to "the lesser of (1) $75,000, or (2) 100 percent of the participant's average compensation from the employer during his highest three consecutive calendar years of aggregate earnings during the period he was an active participant in the plan."; S. Rep. No. 95-1263, at 94 (1978), a Senate Finance Committee Report that explains a new rule contained in the Revenue Act of 1978 for participants in collectively bargained pension plans [ § 415(b)(7)] [and that describes the rule in § 415(b)(3) in terms of "the highest three consecutive years of participation"].

We note that the Service apparently is willing to diverge from statutory language where a more appropriate approach is possible. For example, the Proposed Regulations do not follow the plain language of the statute with respect to the use of calendar years for service. IRC § 415(b)(3) specifies that calendar years shall be used in determining the participant's average compensation, while the Proposed Regulations provide that "the plan may use any 12-month period to determine a year of service instead of the calendar year, provided that it is uniformly and consistently applied in a manner that is specified under the terms of the plan."

The regulations read as follows: "*Safe harbor for certain grants of benefits for past periods.* The timing of a plan amendment that credits (or increases benefits attributable to) years of service for a period in the past is deemed not to have the effect of discriminating significantly in favor of HCEs or former HCEs if the period for which the service credit (or benefit increase) is granted does not exceed the five years immediately preceding the year in which the amendment first becomes effective, the service credit (or benefit increase) is granted on a reasonably uniform basis to all employees, benefits attributable to the period are determined by applying the current plan formula, and the service credited is service (including pre-participation or imputed service) with the employer or a previous employer that may be taken into account under §1.401(a)(4)-11(d)(3) [without regard to §1.401(a)(4)-11(d)(3)(i)(B)]. However, this safe harbor is not available if the plan amendment granting the service credit (or increasing benefits) is part of a pattern of amendments that has the effect of discriminating significantly in favor of HCEs or former HCEs."