HANSON BRIDGETT'S Employee Benefits LAW UPDATE

MAY 2007, ISSUE 1 Published by the Hanson Bridgett Employee Benefits Law Practice Group www.hansonbridgett.com

Highlights For Public Retirement Systems of New Section 415 Regulations *By Bob Blum*

On April 5, 2007, the IRS published new section 415 regulations. 72 Fed. Reg. 16878. These regulations solve one critical issue for most public sector retirement systems — how to treat COLAs. They also have many other detailed technical provisions that can affect the calculations for 415 compliance. For the most part, the regulations are effective for public retirement systems for the calendar year that begins more than 90 days after the "close of the first legislative session" of the body that has authority to amend the plan and that begins on or after July 1, 2007. This memorandum focuses on the highlights for public sector defined benefit systems; it does not go through the many technical changes that may affect testing calculations because we strongly recommend that systems rely on their actuaries for this work.

1. COLAs, Generally

The proposed regulations had the potential for creating a serious problem. They implied that the present value of COLAs had to be taken into account at the time that benefits begin effectively reducing the dollar limits under section 415. The effect for many public systems would have been to reduce those limits by about 30%. For example, the current dollar limit of $180,000 for benefits beginning at age 62 would be reduced to about $126,000 at age 62 for both safety and general members. At age 55 the limit would be reduced to about $75,000 for general members and safety members (such as probation officers) who do not qualify for "safety" under the section 415 rules[1].

For most public systems, the final regulations solve this problem and do not require that the present value of COLAs be taken into account at the time that benefits begin. Instead, most COLAs are taken into account as the benefits are paid. This is the way that most (if not all) public systems have dealt with COLAs so they can continue to do this as long as the required conditions are met.

Here are the conditions, discussed below:

i. The COLA must be an "automatic, periodic" increase

ii. The increase can be annual in accordance with a specified percentage or "objective index"

iii. The form of benefit paid without regard to the automatic increase must comply with section 415

iv. The plan must provide that "in no event will the amount payable to the participant under the form of benefit in any limitation year" be greater than the section 415 limit

v. The benefit must be paid in a form to which Int. Rev. Code sec. 417(e)(3) does not apply

Treas. Reg. 1.415(b)-1(c)(5).

For most COLAs, condition (i) will be met, even if the board of retirement must make an annual determination as to the increase in the cost of living before any COLA increase takes effect. E.g., Gov. Code sec. 31870. Once the board takes this action, then the statutory formula sets the increase. It is reasonable to conclude that this is "automatic" because the board's action is fact finding and the board does not have the ability to grant (or not grant) the benefit[2].

Condition (ii) is the essence of most COLAs. Either they specify a stated percentage per year of increase or they are tied to an index such as the CPI. So (ii) should be met in most cases. If the COLA formula provides the higher of a fixed percentage or the actual CPI (probably with a cap), this should meet the rules as well because there is a fixed formula; however, the regulations do not directly cover this situation.

[1] Never trust lawyers, including us, for numbers. These numbers are only for general "in the ballpark" comparisons. Always consult your actuary about numbers.

[2] See below re Ad Hoc COLAs, though.

Condition (iii) merely says that the plan must comply with section 415 without regard to the COLA. If this condition is not met, the plan has bigger problems than the COLA.

Regarding condition (iv), you might think that an overriding provision in the governing documents that all benefits must comply with section 415 would do the trick. That does not seem to be the case. In discussions with a senior technical advisor in the IRS, we were told that the COLA benefits provision must additionally include language that limits the total benefits so they do not violate section 415. This is easy to do, and it appears that it should be done because there is no reason to take the risk of not including these words.

As for (v), this is highly technical, but boils down to the payment of lump sums. Few California public systems pay lump sums. Furthermore, at least one major system that does pay lump sums does not take into account COLAs in calculating their value. So, while this could be an issue in some cases, it appears to be rare.

2. Ad Hoc COLAs

There could be an issue for condition (i) above when the board of retirement exercises discretion to provide an ad hoc COLA. E.g, Gov. Code sec. 31873.3(a) (ad hoc COLA can be paid from "excess earnings"). Generally, it seems fair to conclude that this is not "automatic". But in that case it is also very difficult to put a present value on that benefit at the time when benefits begin, so the logical conclusion should be that the only time that an ad hoc COLA is tested is at the time of payment. This would seem to come under the rules concerning "multiple annuity starting dates". These rules are a bit unsettled.

The part of the regulation that specifically deals with multiple annuity starting dates is silent ("reserved") and we are told that Treasury is working on new regs for this issue. Treas. Reg. 1.415(b)-2. However, the final regs also state that in the case of multiple annuity starting dates, each payment must meet the 415 rules. Treas. Reg. 1.415(b)-1(b)(1)(iii). This seems right and there is language in the final regulations that leaves wide open the door for the IRS regarding the method of testing. Therefore, when there is an ad hoc payment, then it should be aggregated with all other payments and the total tested against the section 415 limits. Technically, this requires that all payments from the first date that a retirement benefit was paid must be turned into a straight life annuity, and tested under section 415. There are a number of technical questions about how this should be done, so it is important for each system to work with its actuary on this issue. Future changes in the regulations should clarify the rules for ad hoc COLAs.

In some cases, boards of retirement have reserved substantial assets for paying these types of COLAs, have set policies to make the payment, have done actuarial studies to be sure that they can be paid for decades, and have made payment for many years. Based on other provisions in the tax law, it is not unreasonable to conclude that these types of COLAs are also "automatic" until the policies, pattern and practice are changed. See Treas. Reg. 1.411(d)-4(c)(1) (pattern of repeated plan amendments providing for similar benefits in similar situations for substantially consecutive periods of time treated as provided under the terms of the plan).

3. Rollovers to Purchase Service Credit

The final regulations confirm that, for purposes of section 415 testing, the actuarial factors that must be used to determine how much of a benefit is paid for with rollovers are not the same as the factors generally used by retirement systems. This can push additional benefits into a replacement benefits plan.

Generally, the annual benefit subject to the section 415 limits does not include the benefit attributable to rollover contributions. Treas. Reg 1.415(b)-(b)(1)(B)(ii). Under the prior regulations, the benefit attributable to rollovers was "determined on the basis of reasonable actuarial assumptions." Treas. Reg 1.415-3(b)(1)(iii). But the new, final regulations require that a different set of actuarial factors be used. The actuarial factors that must be used under the final regulations to determine what amount of benefit is attributable to a rollover are the factors under Int. Rev. Code sec. 411(c), which otherwise only applies to the private sector. Regs 1.415(b)-1(b)(2)(v). In many cases, these assumptions are not as favorable to the member as are the factors used by systems for this purpose[3].

The effect is that in some cases the regulations will treat some benefits as paid for by the employer and not by the employee even though the retirement system is sure that it charged the employee the full cost of the benefit. The consequence will be that more benefits will be paid from a replacement benefits plan (authorized by Int. Rev. Code sec. 415(m)) than may be expected. This only may be a technical issue, though. There may not be any additional financial burden on the sponsoring

[3] The regulations require that a minimum interest rate be credited to after tax contributions and apparently to rollovers as well to determine the amount that is then converted into a single life annuity to reduce the benefit subject to the 415 limits. The rate is determined as if the public sector plan were an ERISA plan. The problem, however, is that this is not the case and it would be a rare situation if the public system tracked the required interest rates. Your actuary should be able to do this with ease, however.

agency because the contributions of the agency that pays the replacement benefits may still be adjusted to take account of the benefits paid by the replacement benefits plan. E.g., Cal. Gov. Code sec. 31899.4

As under the proposed and prior regulations, the actuarial factors under section 411(c) also apply to determine the amount of benefit paid for with after tax contributions. Reg. 1.415(b)-1(b)(2)(iii). Service credit purchased with pre-tax pickups is treated as paid for by the employer, so the entire amount of the benefit from this purchase is subject to section 415 testing. Treas. Reg. 1.415(b)-1(b)(2)(ii).

It is important to note that the final regulations do not include in-service plan to plan transfers from a 415(b) "eligible" deferred compensation plan as a "rollover" governed by the above rules. In defining what is a rollover, the regulations explicitly exclude this type of transfer. The tip-off is that the regulations include rollovers from 457(b) plans that occur when a member terminates service (by reference to section 457(e)(16)) and do not include any reference in the definition of rollover to in service transfers from a 457(b) plan which are governed by section 457(e)(17). See Treas. Reg. 1.415(b)-1(b)(1)(B). It is highly unlikely that this was an inadvertent omission.

The preamble to the proposed regulations state that section 415(n) governs the treatment of in-service transfers from a 457(b) and a 403(b) plan that are used to purchase service credit under a defined benefit plan. 72 Fed. Reg. 16898 (4/5/07). Section 415(n) does not provide for any exclusion from testing for this type of purchase and instead says that "the distribution rules applicable under [the tax laws in general] . . .shall apply" to the defined benefit public sector system that receives the transfer. Int. Rev. Code 415(n)(3)(D). This language is sufficiently broad to require that the benefits purchased with an in service transfer from a 457(b) plan be tested under section 415(b). However, this result makes no sense. Why should a rollover that is in service be treated differently for 415 testing than a rollover that occurs after the member terminates? Hopefully, the IRS will clarify this in the near future.

4. Special "Safety" Rule and Military Service

Employees of organizations (or departments) that provide police, firefighting and emergency medical services, and who have 15 years of service under the retirement system as employees of those departments, are exempt from the actuarial reduction of the dollar limit. Int. Rev. Code sec. 415(b)(2)(H). The tax law also includes service as a "member of the Armed Forces of the United States" in that rule. Id.

The final regulations include an example that provides that years of service in the Armed Forces can be tacked onto years of service in, e.g. a police department to meet the 15 year requirement. This is a new, generous application of the rules. Treas. Reg. 1.415(b)-1(e)(1) Example (6).

5. Effective Date

Generally, the regulations are effective on the date of publication, but apply to "limitation years" that begin on and after July 1, 2007. Treas. Reg. 1.415(a)-1(g)(1). However, there is a special effective date for public sector retirement systems. Treas. Reg. 1.415(a)-1(g)(2). For governmental plans, the regulations apply to limitation years that begin more than 90 days after "the close of the first regular legislative session of the legislative body with authority to amend the plan that begins on or after July 1, 2007." Treas. Reg. 1.415(a)-1(g)(2). However, the plan may choose to apply all (not just a selected few) of the new regulations to limitation years beginning after July 1, 2007. Id.

For most public systems, this means that the new rules start to apply at the beginning of a calendar year. "Limitation year" is not the same as fiscal year or even "plan year". Under the regulations, the limitation year is the calendar year unless the system has affirmatively elected a different twelve month period. Treas. Reg. 1.415(j)-1(a). Systems have rarely elected a different period because it is usually easier to administer the section 415 rules on a calendar year.

6. Grandfather Rule

A retirement system is grandfathered under the old rules for the limitation years before the effective date of the new regulations if the plan provisions met the 415 rules under the statute, regulations and "other published [IRS] guidance" issued before the new final regulations. Treas. Reg. 1.415(a)-1(g)(4). However, if benefits are earned after the effective date of the new regulations, then the total benefit including those earned in prior years must meet the new rules. In some situations, this could freeze new accruals for a period of time.

7. Amendments to Governing Documents

The preamble to the final regulations says that, generally, plan amendments to comply with these new regulations must be made by the time (including extensions) for filing the employer's tax return for the 2008 year. 72 Fed. Reg. 16893 (4/5/07). This gives until the fall of 2009 for plan amendments for most private sector plans. The preamble says that this applied if the "plan is not a governmental plan" but does not give any guidance for governmental plans. At worst, however, governmental plans should not be treated more stringently than private sectors plans. Note that the plan must operate in accordance with the new rules before the governing documents are amended. This may work in the private sector, but because of vested rights it may be best for public systems to be amended sooner than the last date allowed by the IRS.

Many public retirement systems have only a short, cursory set of rules that are intended to meet the requirements of section 415. However, most private sector retirement plans include many pages of very technical rules that are often required for the IRS to issue a favorable "determination letter" on the plan. The new regulations do not require any special plan language Treas. Reg. 1.415(a)-1(d)(1). They only require that the plan document "preclude the possibility" that any distribution will exceed the section 415 limits. Id. However, when the regulations offer options to the plan the governing plan document specify which option is chosen. Id. Furthermore, in certain cases to take advantage of favorable rules, the regulations require that the governing document specifically include the rules.

Here are some examples of what should be in the governing documents:

i. The COLA provisions should explicitly prohibit the COLA from being paid if the benefit would exceed the section 415 limits, as explained above.

ii. If the system wants to pay increased benefits as the IRS section 415 COLA factors increase the dollar limit, then the governing documents must provide that the IRS COLA applies to previously retired members. Reg. 1.415(a)-1(d)(v).

Under these new rules, it would be best if all public systems reviewed their provisions on section 415 and that the governing documents be amended as appropriate. This may require statutory amendments to statutes such as those governing CalPERS and the 37 Act systems[4].

There is a difference of opinion on whether it is better to adopt amendments as early as possible or wait. In the private sector, retroactive amendments arising out of new IRS rules are generally accepted. There is not much experience with this in the California public sector. The main issues may be political (trying to get the Legislature to understand why statutory change should be retroactive), and "vested rights".

DISCLAIMER: This publication does not constitute legal advice. Readers should consult with their own legal counsel for the most current information and to obtain professional advice before acting on any of the information presented. Copyright © Hanson, Bridgett, Marcus, Vlahos & Rudy, LLP, 2007

For more information, please contact:

www.hansonbridgett.com

4 An interim step might be for the affected system to adopt regulations while it waits for the Legislature to act.