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Maximum Benefit Limitations

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Summary: Figuring out how much you can pay from a qualified pension plan isn't as simple as it used to be. Thanks to the General Agreement on Tariffs and Trade and the Small Business Job Protection Act, Section 415 rules have gotten quite complex. Revenue Ruling 98-1 provides the methodology required for determining maximum benefits payable from defined-benefit plans, but it s far from a simple read.

Mr. Victor A. Kamat: This is a session on maximum benefit limitations. The two presenters are myself and Roscoe Haynes. I'm an associate with William M. Mercer; Roscoe is with Milliman & Robertson. We are going to divide this session into five parts. The first is background concepts. The second is on Section 415(b) for defined-benefit (DB) plans. The third addresses Section 415(c) for defined- contribution (DC) plans. The fourth is on Section 415(e), which is for coordinating DB and DC limitations. The final Section is on sanctions for violations of Section 415.

Before ERISA, there were no real limits on the amount of benefits that could be provided to an individual plan participant; the only effective limitations were those that controlled the sponsor s deductions under Section 404. Starting with plan years beginning after 1975, ERISA imposed benefit and contributions limitations at the individual level.

Section 401(a)(16) provides that a retirement plan trust is qualified under Section 401(a) only if the plan does not provide "for benefits or contributions which exceed the limitations of Section 415." This is repeated in Section 415(a)(1).
Similarly, a nontrusteed retirement annuity plan is qualified under Section 403(a) only if the plan satisfies the requirements of Section 404(a)(2), which incorporates by

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reference the requirements of Section 401(a)(16). This is repeated in Section 415(a)(2)(A).

A Section 403(b) tax-deferred annuity and a simplified employee pension must also comply with Section 415 limitations, Internal Revenue Code (IRC) Section 415(a)(2)(B) and (C).

Section 415 has three different kinds of limitations on individual benefits and contributions. Section 415(b) prescribes limits on the maximum benefits that may be paid to a participant under an employer's DB plan. Section 415(c) prescribes limits on the maximum annual additions that may be made in any one year to a participant's account under an employer's DC plan.

For limitation years beginning before January 1, 2000, Section 415(e) prescribes coordinated limits where a participant is covered under both a DB plan and a DC plan of the same employer. These limits may in turn be affected if the plans are top-heavy or super top-heavy under the rules of Section 416. The 415 rules are applied using rules that aggregate both separate plans and separate employers.

IRC Section 415(f): All of an employer's DB plans (both currently active and those previously terminated) are treated as a single DB plan, and all of its DC plans (active and terminated) are treated as a single DC plan.

The plans of two or more legally distinct entities may have to be treated as being maintained by a single employer for this purpose under the rules of Section 414(b), 414(c), 414(m), and 414(o). Note that the 80% overlapping control test normally used under Sections 414(b) and (c) is reduced to 50% pursuant to Section 415(h).

However, if an individual participates in separate plans of separate employers that are not aggregated under these rules, the individual may reach the maximum limits under each employer's plan(s); the 415 rules are basically employer-specific. Benefits or contributions provided under the plans of truly separate employers are aggregated only if they are provided under a single plan maintained by the employers.

Multiemployer plans are not aggregated with other multiemployer plans. They are aggregated with single employer plans, but only to the extent that the multiemployer benefits are based on service with the employer. This is
Regulation- §1.415-8(e).
Regulation 1.415-1(e) states that a multiemployer plan may apply the limits on an aggregate or an employer-by-employer basis.

If an individual has participated in separate plans of separate employers which at some point become related in a manner requiring aggregation for Section 415

purposes and the 415 limits are violated once the plans are aggregated, Regulation §1.415-10 prescribes rules that basically grandfather the participant's accrued benefits under all plans, provided the benefits are frozen until the participant's continued service and compensation permit the resumption of accruals.

The 415 rules apply to any plan on the basis of its "limitation years," a term coined by Regulation §1.415-2(b) in response to the authority granted by Section 415(j). A plan's limitation year is the calendar year unless the employer has elected otherwise. An employer may elect any other 12-month period as the limitation year. The election is made "by the adoption of a written resolution."

All members of a related group of employers who constitute a single employer under Section 414 rules and maintain the same plan must adopt the same limitation year with respect to that plan.

One or more employers that maintain one or more separate plans may adopt a different limitation year with respect to each plan. If different years are used, the 415 limits must be satisfied as to each plan for its own limitation year, with complicated rules applying in the case of those participants covered in plans with different years. The applicable rules are spelled out in Revenue Ruling 79-5, 1979-1 C.B. 165.

A limitation year may be changed by employer resolution to any other 12-month period beginning in the current limitation year. Regulation §1.415-2(b)(4) notes that, with a DC plan, the less-than-12-month period from the beginning of the current year to the last day before the beginning of the new year becomes a special "limitation period" (discussed further below).

The 415 limitations are applied using a very specific definition of a participant's compensation set forth in Regulation §1.415-2(d). This definition must be used for 415 purposes regardless of the definition used by the plan for benefit accrual or allocation purposes.

Compensation includes all cash wages shown on Form W-2 for an employee (including certain foreign-earned income exempted from income taxes), and all "earned income" as defined in Section 401(c)(2) for a self-employed person's earned income is a net figure after the deductions for retirement plan contributions on his or her behalf. Compensation also includes taxable noncash fringes, such as premiums for group life coverage over $50,000, the value of a nonqualified stock option or other restricted property as to which an employee makes a Section 83(b) election at the time of grant, and amounts received under an unfunded nonqualified deferred compensation plan. For limitation years beginning after 1997, compensation also includes amounts deferred under a Section 401(k) plan, a Section 125 plan, a Section 403(b) annuity program, or a Section 457 plan.

Compensation does not include distributions from retirement plans or the income recognized upon exercise on a nonqualified stock option, disposition of stock acquired under a qualified or incentive stock option, or the vesting of restricted property where no Section 83(b) election was made.

Compensation does not include S-Corporation shareholder's share of the corporation s taxable income that is passed through to him or her on Schedule D-1; it wasn't shown as compensation on Form 1120-S. Nor does compensation include a partner's share of a partnership's net distributive income to the extent that such share doesn't amount to "net earnings from self-employment."

Compensation is determined on a cash basis (taking into account amounts constructively received), unless the employer has elected to use the accrual basis. Note that accrued pay may be used even though the employee remains on the cash basis. This is Regulation §1.415-2(d)(3) and (4).

Section 415(b) limitations for DB plans: Under Section 415 (b)(1), a participant s annual benefit under all of an employer's DB plans may not exceed the lesser of $90,000 or the dollar limit currently in effect for the calendar year in which the limitation year ends, ($130,000 in 1999) and 100% of the participant s average compensation for his or her highest paid three consecutive years with the employer.

The dollar limit rose from $75,000 in 1976 to $136,425 in 1982 and was $90,000 from 1983 to 1987; it is adjusted annually to reflect cost-of-living adjustment (COLA) changes in the manner used to adjust Social Security benefits. Refer to IRC Section 415(d), the adjustment is rounded to the next lower $5,000.

The maximum dollar limitation assumes an annual benefit commencing at the participant's Social Security retirement age (SSRA) payable as a single life annuity. The dollar limitation is reduced to reflect the greater value of a benefit that begins earlier. This reduces the limit to about $58,000 in 1999 if retirement occurs at age 55. Refer to IRC Section 415(b)(2)(B) and (C) the reduction is based on Social Security factors to age 62 (5/9% and 5/12%), and actuarial equivalence below age 62. The adjustments below age 62 are as follows.
Before December 7, 1994, the dollar limits were the lesser of those based on plan interest and 5%, both with plan mortality. Effective December 7, 1994 through December 20, 1996, the limits were changed to compare plan factors (mortality and interest) with GATT mortality and 5% interest for monthly benefits and GATT interest for lump sums. Effective December 20, 1996, the use of GATT interest rates for the lump-sum age adjustment was changed back to 5%.

To the extent benefits are not forfeited on death, the plan may disregard mortality below age 62 in making this adjustment.

The dollar limitation is increased to reflect the lesser value of a benefit that begins after the participant's SSRA. Refer to IRC Section 415(b)(2)(D), to the extent benefits are not forfeited on death, the plan must disregard mortality after SSRA in making this adjustment.

Plans maintained by governmental and other tax-exempt employers that went into effect before the Tax Reform Act of 1986 continue to enjoy the advantages of the prior rule, namely that no reduction is required in the dollar limitation if benefits don't begin before age 62; the limitation can't be less than $75,000 at age 55. There are also more lenient rules for plans covering police, firefighters, merchant marine officers, union members, and commercial airline pilots. Refer to IRC Section 415(b)(2)(F), (G), (H), and (I), Section 415(b)(7), Section 415(b)(9), and Section 415(b)(10).

Section 415(b)(3) has always provided that the highest three years had to be years in which the individual "was an active participant in the plan," but Regulation §1.415-3(a)(3) has always spoken in terms of years of service or employment, not participation. The years are to be calendar years, or any other 12-month period applied to all participants.

The 100%-of-high-three-pay limit is also adjusted under Section 415(d) for COLA changes after a participant's termination of service so that a plan may provide a COLA-indexed benefit that grows past 100% of a participant's average pay. The adjustment is based on the underlying COLA factors, not on the rounded increase in the dollar limit.

The 100%-of-high-three-pay limit may be exceeded as long as the participant's benefits aren't more than $10,000 per year and he or she has never participated in any DC plan maintained by the same employer. This limit is not adjusted on account of benefit form or benefit commencement before or after age 65. Refer to IRC Section 415(b)(4).

The limits are reduced if the form of benefit is not "life only." However, adjustment is required where the benefit is paid in a form meeting the requirements of a qualified joint and survivor (J&S) annuity to the participant and his/her spouse, rather than as a life annuity, but this exception applies only where the benefit is actually paid as a J&S annuity, i.e., a plan may not distribute a lump-sum equivalent of a J&S annuity paying the maximum $90,000 per year.

Before December 7, 1994, a benefit that is not life only (or J&S) is adjusted to life only. The adjustment factors are the greater of those based on plan interest and 5%, with plan mortality.

Effective December 7, 1994, new factors apply to converting to life only. For benefits not subject to 417(e)(3), the monthly benefit factors are the greater of those using plan factors (mortality and interest) and "GATT Monthly" factors—GATT mortality and 5% interest. For benefits subject to 417(e)(3) "lump sums,", the factors are the greater of those using plan factors and "GATT lump-sum" factors—GATT mortality and GATT interest.

The pre-December 8, 1994 limits may be grandfathered as of the freeze date selected by the plan sponsor, which cannot be later than the first day of the first limitation year starting in 2000. For the old law benefit, the plan accrued benefit on freeze date is payable on determination date, using assumptions, factors, and methods in effect on determination date. The total benefit plan accrued benefit is payable on determination date with assumptions, methods, and factors on determination date. The new law benefit is the difference between the total benefit plan accrued benefit and the old benefit.

Here's an example of how these adjustments are made. We have a participant who terminates in 1999 at age 60. His annual accrued benefit at age 65 payable as a 10-year certain and life (C&L) benefit is $120,000. The benefit at age 60 using plan factors is $80,000 and his high three-year average compensation is $220,000. Under step one we first convert the plan benefit to life only. The plan benefit at age 60 under 10 C&L is $80,000. We then convert these plan benefits from 10 C&L to life only, at the same age, using plan interest and mortality. That comes out to be $86,000. We then convert the plan benefit from 10 C&L to life only, at the same age, using 5% interest and applicable mortality, which is $86,500. The equivalent annual benefit is the greater of the $86,000 and $86,500, or $86,500. We next convert the statutory dollar limit at SSRA to age 60 when the plan benefit is payable. The 415 limit at SSRA is $130,000. Reduced to age 62, we have $104,000. That's multiplying the $130,000 by 80%. The reduction from age 62 to 60 using plan factors is $86,580 and the reduction from age 62 to 60 using 5% and applicable mortality is $88,858. The age-adjusted dollar limit is the lesser of the $86,580 and $88,858, or $86,580. The equivalent annual benefit of $86,500 which we have from step 1, does not exceed the age adjusted benefit of $86,580. In this case the plan provided a benefit of $80,000 as a 10 C&L which meets the 415 limitation for the plan.

Mr. Roscoe Haynes: Example 1 was based on a benefit that is not subject to 417(e)(3). Example 2 shows a lump-sum benefit that would be subject to 417(e)(3).

In this example the plan lump sum is the present value at UP84 using 6%. This lump sum was calculated as equal in value to the early retirement benefits. In other words, we took the present value of the early retirement benefits to get this lump sum. The plan has been amended to apply 415(b)(2)(E). The plan uses the new GATT assumptions for converting to a life only form. For this example the lump sum before the 415 limits is $1 million, and I'm assuming that the 1999 applicable interest rate for 415 limits is 5.25%. The three-year average compensation is $220,000. Note that the $220,000 is more than the $160,000, but for 415 that doesn't matter. According to 415, the benefit cannot exceed the 3-year average compensation; the $160,000 limit does not apply.

We go through a similar step 1 conversion. I recommend that when you are testing 415 benefits that you use step 1 and step 2. It's described in the revenue ruling and will help you get to the right number, even though it's not necessarily the intuitive way of doing it. Things get a little complicated when you start using the transition rule if you don't do it this way.

The first step is to convert the $1 million lump sum using plan factors. In this case that was 6% and UP84 to get $94,375. Then we do the same thing using the 5.25% and applicable mortality (GATT) factors to obtain $78,511. The benefit that we re going to test against is the larger of these two. That benefit is our life-only benefit for 415 purposes. In step 2 we convert the statutory SSRA benefit down to 62. The procedure is very similar to what we did with non lump-sum benefits. We first take the SSRA benefit down to age 62, from $130,000 down to $104,000; we then do the reduction from 62 to 60. In this case the plan has an early retirement factor of 4% per year. The plan reduction factors from 62 to 60 are 80% and 88%. Even though the plan has an actuarial equivalence of UP84 6%, that's not what the plan uses to get early retirement benefits. We have to use whatever the plan uses for early retirement, which is 80% over 88%. The result is $94,545. Then, of course, the next adjustment is to do the reduction from 62 to 60 using the GATT factors under the Retirement Protection Act. In this case the plan has no forfeiture on death and the plan permits the exclusion of preretirement mortality from the adjustment. Your plan needs to say that you're going to exclude preretirement mortality to use this option. That brings us down to $90,126. The lower of these figures ($94,545 and $90,126) will be our maximum annual benefit at the retirement age. We take the $1 million lump sum that we wanted to pay, before 415 limits, and multiply it by the ratio of the $90,126 (our maximum annual benefit) divided by $94,375 (the equivalent annual benefit). The $1 million lump sum is equivalent to $94,375. We need to reduce that $1 million down so that the equivalent annual benefit will only be $90,126. That gives us a maximum lump sum of $954,977.

I'd like to just do a couple of tweaks on this adjustment. I'll call this example 2a. This is explained in the 1998 gray book under question and answer 10. The reason

I'm doing this example is that on most of my plans when I calculate a lump sum, the lump sum is a deferred annuity factor times the normal retirement benefit. In example 2 the lump sum was based on an immediate annuity factor times the early retirement benefit to get the lump sum. If you're doing the lump sum based on a normal retirement benefit, then you won't include the early retirement subsidy in the lump sum. If you do it based on the early retirement benefit, the subsidy goes into the lump sum and you have a subsidized lump sum. In this example consider paying a lump sum of $825,783.

Now one would think everything would just follow step 1. One would take the $825,783 and divide that by the plan's factor to get the equivalent annual benefit that the plan pays and then do the same thing with the GATT factors to get the equivalent annual benefit under those assumptions. But that's not correct. The gray book says, and if you read the Revenue Ruling carefully you'll see, that we need to first convert from the lump sum to the early retirement benefit. We can no longer use a straight actuarial equivalent factor. The factor here turns out to be 8.742. This takes into account the subsidized early retirement.

If I could use the actuarial equivalent factor, the maximum lump sum would be the same as when I based the lump sum on the early retirement age. One would think the maximum lump sum would not change regardless of whether you're paying a subsidized lump sum or an unsubsidized lump sum. But, actually that's not true. If you don't pay a subsidized lump sum, the maximum lump sum is reduced. It does make sense because if the rank and file who are not affected by 415 limits don't get a subsidized lump sum at early retirement, the plan must also reduce the lump sum at early retirement for those who are affected by 415 as well. I'm assuming that this is the rational explanation for it.

Let me just do one other little tweak to this example, and I will call this example 2b. Let's say that instead of having just the straight 4% early retirement factors, this plan pays an unreduced benefit at age 62. Now, our person is retiring at age 60 and there's an 80% reduction at age 60. The fact that there's an 88% benefit or a 100% benefit at age 62 really has no impact on the person we're looking at. The plan has an unreduced benefit at 62, and the rules say use actual plan factors to convert from age 62 down to your actual retirement age. You can see that the adjustment really socks the maximum annual benefit and cuts it down to about $83,200. Our maximum lump-sum benefit gets cut down to $728,000. If the person stayed to 62 they could get this unreduced benefit. If you want to maximize lump sums on early retirement, I think the strategy is to not offer an unreduced benefit at age 62. Offer it instead at age 62 and one month, because the conversion doesn't look at what the benefit is at age 62 and one month, or age 62 and two months. It looks at what the benefit is at age 62. By having an unreduced benefit available at age 62 you really hammer the 415 limits at the earlier ages. Does that make sense? No. That's just the way it is.

There are a few transition rules outlined in examples 3 and 4, but I think at this point I'm going to jump ahead and we'll come back to the transition rules at the end. The transition rules are described as methods 1, 2, and 3.

The DC limits are described in 415(c). The dollar limit is $30,000 and the compensation limit is 25% of pay. The $30,000 is based on the calendar year in which the limitation year ends. You generally want to have a plan year that matches your calendar year; otherwise, if the $30,000 goes up in the year 2001 and you're in the year 2000, you don't know what the limits are until they are published. These limits are based on annual additions, which are employee contributions, forfeitures, and employer contributions. The outline goes into detail about how to handle excess 401(k) deferrals that are disgorged from the plan or make up contributions, or the fact that participant loan repayments are not considered to be employee contributions. Plan-to-plan transfers are not included as additions either.

Combined plan limits under 415(e) apply when a sponsor has both a DB plan and a DC plan. We have to either reduce the DB or we have to reduce contributions to the DC plan. The gist of it is that the sum of the DB fraction and a DC fraction has to be limited to 1.0 when we add them. The sponsor has to restrict the benefits to avoid exceeding these limits.

For the DB fraction, the numerator is the annual DB. Going back to our examples, the numerator is the step 1 benefit—the benefit converted to a life-only amount at the payment age. The denominator is 1.25 times the dollar limit—the step 2 benefit from our example. It's the dollar limit converted to the age at which the benefit is going to be paid. There's actually an array of 415(e) DB fractions depending on the retirement age. Each age has its own numerator and its own denominator. But be sure to note one more detail on the DB fraction. The dollar limit is reduced for less than ten years of service, but not for less than ten years of participation. Also, we must bring in all DB plans, even those that have been terminated, distributed, or paid out, even if the benefit was forfeited. Whatever DB the person accrued, all the plans are aggregated together even if the plan has been terminated.

For 415(e), there's an even wider definition of a controlled group. Benefits for a 5% owner of an enterprise are carried forward later on and combined with those of another later enterprise if the person is again a 5% owner. This was typical where a doctor would be a junior partner in a group practice with a 5% ownership. Later the doctor would set up his or her own practice where he or she owned the whole thing or owned 50%. We need to go back and grab that first benefit from when he was a 5% owner.

For the DC fraction, the numerator is the sum of all annual additions—all employee contributions, employer contributions, and forfeitures. For years when employee contributions were only counted as the excess over 6%, we could use that special rule. The denominator is based on all the years for which you could have had a plan, not just the years that you had a plan. If an employer is putting in a DC plan this year and you have people with a lot of history you really have no problem with the DC fraction because you could include all those years when they could have had a contribution and put them in the denominator. The numerator would just be this year's contributions. You get to start off with a really small fraction. And, once again, the numerator includes all enterprises in which the participant was at least a 5% owner.

Now, there were some reductions in 415 limits from the Tax Reform Acts of 1982 and 1986 and TEFRA. The regulations specify reductions to the numerator of the DC fraction and other adjustments. The rules are all detailed excruciatingly in your handout. There are adjustments to both the numerator and the denominator.

If a plan was top-heavy, instead of using 1.25 times the dollar limit in the denominator we'd use 1.0 times the dollar limit, unless the plan provided for either a minimum contribution to the DC plan or a minimum benefit to the DB plan.

Where an employer has more than one plan or there is a controlled group with several plans, the IRS has discretion on which plan will be disqualified or penalized. The IRS will disqualify active plans before they disqualify a terminated plan. If they disqualify a terminated plan that affects people's IRA rollovers, so it's better that they don't disqualify terminated plans. They also disqualify single employer plans before multiemployer plans. If you have somebody who is in a multiemployer plan and a single employer plan, the single employer plan must aggregate them in testing. Generally, I recommend plans specify that the DB plan is limited, not the DC. A DC contribution is a violation if the fractions exceed 1.0 in any year. That would disqualify the plan or create a sanction or the need to do a correction. With the DB plan you have a risk only when the benefit is actually paid. You can go on year by year doing the calculations wrong or not doing them at all and not create a 415 violation. You may have a funding problem with deductibility, but you haven't actually violated 415 until you pay the benefit from the DB plan.

Some employers may not be starting a new DB plan currently because the combined plan limit still applies. But if you set up a DB plan where the combined plan limits limit you to zero, that's not necessarily a bad idea because of the ten-year phase-in based on years of participation. You can set up the DB plan this year, in 1999, and get a jump start on your ten-year phase-in.

Now, one way to work around 415 is to set up a nonqualified excess plan. If it's an unfunded plan it's exempt from Title I of ERISA completely. Even if it's funded it is exempt from participation, vesting, and minimum funding. These plans are really good as far as solving the problem for larger employers, and some multiemployer plans are looking at this now as a solution. Multiemployer plans tend to run up against the 100% of pay limit more than dollar limits.

There is some proposed legislation that is interesting as far as 415 goes. HR-1102 would raise the DB limit from $130,000 to $180,000. And the DB reductions would only start at 62, so that limit would apply all the way down to age 62. The age 55 floor that currently applies to nonprofits would be raised from $75,000 to $130,000, but just for nonprofits, governmental plans, and multiemployer plans.

Mr. Colin England: What do you think the odds of this passing are?

Mr. Haynes: This is in a bill that also includes many other good things. There is some chance that it could get through. There have been proposals to raise multiemployer limits in practically every single session of Congress, and a couple of them have come very close to getting through.

Mr. John R. Kaleas: I would like to see clarification about what you said before, because we've run into this before about compensation for 415 purposes not being limited by the 401(a)(17) limit. For example, somebody has at least ten years of service. For ten years participation, their compensation is zero for every year, except for one year when it was $300,000. What is their three-year average for purposes of the plan document, and what is their three-year average for purposes of 415?

Mr. Haynes: I don't know what it is for the plan document. It's whatever your document says.

Mr. Kaleas: The plan document would apparently have a 401(a)(17) limitation that could impact the definition of compensation you could use. I realize some documents could have different definitions for 415 compensation and regular compensation.

Mr. Haynes If your plan is written to say for all purposes compensation is limited to $160,000, then for all purposes compensation is limited to $160,000. But if it says the compensation is limited for determining the benefit to $160,000 and is explicit that this limit does not apply to 415, then you don't have the limit for 415. I'm sure there are a lot of documents that just limit it to $160,000 for all purposes. You have to follow the document. The document doesn't have to be written that way. The document could be written so that that $160,000 doesn't apply to 415. I would say if you have a really good definition of compensation for 415 then the average would be $100,000.

Mr. Kaleas: Is there any problem at all then with the plan qualification issues when you re using a 415 compensation exceeding the 401(a)(17) for a given year? And wasn't 401(a)(17) put in there for nondiscrimination purposes in the first place? Do we have a qualification issue by having a dual definition of compensation?

Mr. Haynes: I don't think so. Your formula is still based on the limited compensation. When you calculate the benefit to start with you're using the $160,000 limit. I think that addresses the discrimination issues. The 415 is applied after everything else is done.

Mr. Kaleas: I appreciate your answer, and I believe I agree with it. There's part of me that thinks that the IRS could take the position that all zeros could be used except $300,000 in one year; all zeros after that. We're actually using $100,000 for him and he actually gets a benefit accrued on that basis. Is that a problem?

Mr. Haynes: When you calculate his benefit each year, your plan has a benefit formula, perhaps some percentage of salary or some percentage of an average salary. Your average salary is going to be $160,000 with some zeros, so your benefit formula is going to have to be two times pay or three times pay in order to have a benefit that exceeds the 415 limits. For example, your plan could say that the benefit formula is $200,000 a year limited by 415. Then it doesn't even use salary in the benefit formula. That's just your plan provision. All your employees get $200,000 a year limited by 415. So your compensation limit would be $100,000.
Let's move on to example 3. The transition involves an old law benefit and a new law benefit. Example 3 calculates the old law benefit. There are three optional methods. Under method 1, we first calculate the old law benefit. Then the person accrues additional benefits, and we split the total benefit between old law and new law and calculate a maximum benefit. It doesn't always protect 100% of the old benefit, but it can go a long way.

Under method 1, we convert the old law amount to a life only benefit and the new law to a life only benefit and then add them together. Then, we convert the limit to a life-only benefit at the payment age. We then compare them and make the same adjustment as before.

Under method 2 we first convert the old law benefit to a single-life benefit at the payment age. Then we convert the total benefit to the single-life benefit at the payment age. Finally, we take the greater of the two. We compare this with the maximum benefit.

Method 3 is the greater of methods 1 and 2. If you can do 1 and 2, you can do method 3. Note that you're not required to have these transitions. You could adopt all the new rules on December 31, 1999 without any transitional grandfathering.

In this case we have an accrued annual benefit in 1997. Our annual benefit is $130,000, and our lump sum is $1,108,032. The early retirement benefit is $88,400. This is the plan's early retirement benefit that we use to get the $1,108,032 lump sum. We convert that $1,108,032 to the early retirement benefit. One can almost leave this conversion factor out because the lump sum has to be converted to the plan's early retirement benefit using the plan's early retirement factors and adjustments. Whatever you do, you have to end up with the plan's early retirement benefit. We also want to look at the statutory conversion. We do a 5% interest and plan mortality conversion to the payment age. This works out to be $98,422. This is our converted single-life benefit payable based on the benefit earned up until December 31, 1997, which is our freeze date. We ignore the $88,400 plan benefit. Just use the statutory benefit. The freeze date is a date before the date you adopt these new rules; this is the date chosen to protect the benefits. Typically it would be the day before you implement the new provisions, but it could be any time in that period after December 7, 1994. That's our step 1. We've converted the lump sum to an annual benefit payable at the payment age.

Our Step 2 calculation has a couple of little twists to it. The first is that we can't apply any 415 COLA adjustments after the freeze date. The example uses a freeze date back in 1997 when the 415 limit was $125,000. The limit is based on $125,000 even though the limits are going up. Then we convert the benefit to age 62 using the 80% factor. To adjust from 62 to age 60, we first use plan factors. The plan factors here were UP84 and 5% with no preretirement mortality. The example shows the calculation converting from age 62 down to age 60. The statutory conversion uses plan mortality and 5%, so in this case the adjustment is the same, and $86,240 is the maximum benefit. The lump sum at the payment age converts to $98,422, so we need to reduce the lump sum. The reduction is similar to what we did with examples 1 and 2. Multiply the step 1 lump sum by the ratio of the maximum life benefit to the actual life benefit to get the maximum lump sum. This concludes the intermediate step needed to get to the transition rules.

Example 4: Our accrued monthly benefit in 1997 was $130,000, and the lump sum was $1,108,032. Because of additional accruals, our lump sum is up to $1,193,265. We have a limited old law lump sum from example 3 of $970,887 and an old law life only form of $86,240 from example 3. We start with the $1,193,265 total lump sum that we want to pay. We subtract out the old lump sum. That gives us $85,233, our new excess benefit on the actual payment form Now we can go through step 1. To get through this you need to look at the code, the revenue ruling, and examples from the Enrolled Actuaries (EA) Meeting. You'll then start to get an inkling of what you're

supposed to do. We think that this is the right way to do it, but you won't necessarily find all these details in the code or in the revenue ruling or even in the IRS examples from the EA meeting. The available guidance and other materials just aren't comprehensive enough to give you a clear picture of exactly what is supposed to be done.

Let's work through step 1. This seems to be, as far as we can tell, most consistent with what's out there. First we take this $85,233 excess benefit that's based on the new law and convert that to an annual benefit at the payment age. We use the plan factors to get to $6,800, which reflects the subsidized early retirement. Then we use the GATT factors. We're under the new law jurisdiction, so I'm not using plan factors and 5%. Instead, I 'm using the applicable mortality and the applicable interest rate, the 83GAM mortality. I get $6,692 using the GATT factors, and the larger of the two is $6,800. To finish up step 1 we add the unreduced old law benefit ($98,422) to get $105,222. Now we need to go through the step 2 calculation. We want to convert the $130,000 down to $104,000 and then go through the plan factor reduction and the GATT factor reduction to get to $89,689. Now we need to worry about the $105,222 that exceeds the $89,689. We take our old law lump sum, $970,887, and keep it. You only adjust the new law amount. We take our $89,689 new law life only maximum and subtract the limited life-only old law benefit of $86,240. We're protecting the old law and recognizing the increase permitted by the change to the new law. We can go up to this much more than the old law, which gives us $3,449. We multiply that by the smaller of the two factors, from step 1, which gives us 12.5343. When we had our two conversions in step 1, it's whichever one worked out worse. We get our maximum benefit, which is $1,014,118.

You might try going through this just as an exercise and not applying the transition and see what the benefit would have been if you just applied the rules without going through the transition rules in examples 3 and 4. You will find that it's the same maximum as in this example. Going through all this transition didn't buy you anything.

You know it's really important to have a calendar year limitation year. In DB plans if you don't have a calendar year limitation year then, for instance, in the year 2000 the limit is going to go up to $140,000, but we don't know that yet. Let's say you have a July 1 plan year. You're trying to do your July 1 actuarial valuation. What s the maximum for funding purposes? Is it $130,000 or is it $140,000? You don't know. Let's say you have someone terminate in July or August of this year and you want to pay them a lump sum. What's the maximum lump sum? Is it based on $130,000 or $140,000?

From the Floor You can pay a preliminary amount and when you know the true dollar limit you can make an adjustment at that point.

Mr. Haynes Right, but you can't know what the number is now. You have to make an adjustment.

From the Floor You have to make an adjustment when you know the true number and the true limit for the calendar year in which the limitation year ends.

Mr. Haynes Right. Employers have to aggregate multiple plans in testing these limits, but of course if somebody works for one employer and actually accrues up to the 415 maximum and then goes to work for a completely independent separate employer and accrues the 415 maximum they can get the 415 maximum under both plans. If those two employers later on merge, then you d need to freeze the accruals until they were no longer in violation, which might be never.

Just as an aside, if you look at the code and the regulations together you will see that they don't explicitly include DB plans in the 1997 change that added 401(k) contributions and Section 125 plan salary deductions for medical and dependent care to compensation for 415 purposes. If you look at the code carefully you'll see that the Section of the code that was changed was 415(c); for DC plans you can include your 401(k) contributions and Section 125 contributions. They didn't amend 415(b), so what you have to do is go to the regulations 1.415-3 and
1.415-2, which imply that those changes are supposed to apply to DB plans. As far as I know everybody has been including 401(k) salary reduction contributions in salary now for 415 purposes.

Many of these details we have discussed must be in your plan document in order to use them. For example, the indexing of the $90,000 limit. If your plan just says the limit is $90,000, then that's what it is. If you don't have the indexing, then you're still at $90,000. If the plan doesn't say no preretirement mortality to the extent that there's no forfeiture on death, then you have to apply the preretirement mortality, and your 415 limits are not as high as they could be. Similarly, 415 will allow you to index the compensation limit after termination, but your plan has to say that. Suppose you have someone who is limited by the compensation limit and not the dollar limit and your plan says that you can index the compensation limit after they terminate employment. If they terminate employment with a three-year average salary of $80,000 and the benefit would have been $95,000, you could make that $80,000 go up year by year so that they can eventually get their $95,000. But, if you don't have that indexing in your plan then you can't do the indexing. The same with increases in the 415 limit after the SSRA. If your plan doesn't have them you are limited to the number at the SSRA. You must go by your plan terms.

The same goes for the $10,000 floor on benefits. You must have it in your plan for that to apply. I once had a plan where one participant had a salary of about $6,000 a

year, but the plan benefit formula would have provided about $8,000. The $8,000 was payable because they put the $10,000 in the plan. However, if you don't have it in there you can't use it.

From the Floor It is my understanding that the 100% of pay limit is not adjusted for form or for early retirement or late retirement adjustments, right?

Mr. Haynes Yes.