ASPPA
WORKING FOR AMERICA'S RETIREMENT

Comments on Multiple Annuity Starting Dates

February 1, 2006

Department of Treasury
Internal Revenue Service
REG-156518-04

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates this opportunity to further comment on the proposed amendments to the regulations under Internal Revenue Code (IRC) §415 that provide guidance regarding limitations on benefits and contributions under qualified plans (Proposed Regulations).

ASPPA is a national society of retirement plan professionals. ASPPA's mission is to educate pension professionals and to preserve and enhance the employer-sponsored pension system. Its membership consists of almost 6,000 actuaries, plan administrators, attorneys, CPAs and other retirement plan experts who design, implement and maintain qualified retirement plans covering tens of millions of American workers.

This letter is a supplement to ASPPA's prior comment letters submitted on July 25, August 10 and October 12, 2005, and is a follow-up to our meeting with Treasury and IRS representatives on January 9, 2006. It provides some additional analysis on the multiple annuity issue that we raised in the August 10 and October 12 letters. ASPPA appreciates the opportunity to provide further feedback in this critical area.

Background

The Proposed Regulations address the application of the maximum benefit limitations in situations involving multiple annuity starting dates (MASDs). MASDs exist in several situations, including:

- Distributions from another plan that must be aggregated with the current plan under IRC §415(b);
- Changes to benefit payment streams resulting from—
    - Additional benefit accruals;
    - Cost-of-living adjustments other than safe harbor COLAs; and
    - The ability to elect to convert to another form of payment after benefit commencement.

The Proposed Regulations provide that, in the case of MASDs , the maximum benefit under IRC §415 must be adjusted at each Annuity Starting Date (ASD). At each ASD, the entire payment stream must satisfy the IRC § 415 benefit limitations, taking into account all payments, including the payments commencing at the original ASD and the deferred payments contemplated for the later ASDs. Under the adjustment for MASDs, plans must demonstrate that the IRC §415 limit is satisfied as of the later ASD, by showing that future benefit payments are less than (a) the IRC §415 limit as of the later ASD, reduced and (b) by the life annuity that is actuarially equivalent at the later ASD of all prior distributions.

This approach functions properly only in situations in which the IRC §415 limit at the later ASD is at least the actuarial equivalent of the IRC §415 limit at the earlier ASD. This equivalency occurs if all ASDs are before age 62 or after age 65. If, however, the 100% of pay limit applies or if the MASDs span any portion of ages 62 to 65, the reduction of the IRC §415 limit by the actuarial equivalent of prior distributions results in an unnecessarily low remaining IRC §415 limit. This approach particularly affects those individuals whose average compensation is sufficiently low that the compensation limit under IRC §415(b)(1)(B) applies [*i.e.,* the dollar limitation of IRC §415(b)(1)(A) is not applicable].

Consider the following examples:

Example 1: A participant with a high three-year average compensation of $100,000 reaches normal retirement age (NRA) at age 65. Although not retired, the participant begins to draw a life annuity of $100,000 per year. At age 75, the participant retires. The plan sponsor offers a lump-sum option to the participant upon retirement. Under the Proposed Regulations, the maximum lump-sum payable at age 75 would be zero. This result is illogical. Instead, the participant should be able to receive the adjusted actuarial equivalent of his remaining accrued benefit.

Example 2: A participant has a high three-year average compensation of $100,000 and begins to draw an $80,000 annual benefit at age 65. At age 75, the participant retires and the plan terminates. The plan has excess assets and provides that such excess will be used to provide additional benefits to participants. Under the Proposed Regulations, the increase in the participant's benefit would give rise to a second ASD. Even though this participant's benefit never even approached the IRC §415 limit, he would be precluded from receiving a benefit increase because both the past and future payments of $80,000 would be counted against his $100,000 per year future benefit limit.

ASPPA Recommendation

For MASDs, the final regulations should require the following two-step process:

- The entire stream of payments (including both the original payment stream and the revised payment, or stream of payments) must satisfy IRC § 415 as of the initial ASD (with appropriate adjustments for COLAs); and
- As of each successor ASD, the payments to be made on or after such successor ASD must satisfy §415 as of the successor ASD.

The two-step process guarantees overall compliance with IRC § 415 by ensuring, through Step 1, that the overall maximum benefit limit is not violated when comparing all benefits to be paid at all ASDs to the IRC §415 limit in effect as of the earliest ASD. The two-step process also prevents "gaming" the system through use of an early ASD for an insignificant benefit, by limiting the prospective benefit at the second and later ASDs to the IRC §415 limit as of those later ASDs. Please see Example 3 (see Attachment) for an example of how ASPPA's proposal would prevent this abuse.

The limit on benefits that are paid under more than one payment method should have two effects:

- A participant who experiences benefit changes during the distribution period should be in the same benefit position and subject to the same benefit limits as an individual who elects the same payment stream (with all adjustments) at the time benefits began.
- No election should enable a participant, whose benefits met the IRC §415 limit as of the initial ASD, to elect a prospective payment stream prospectively that violate IRC §415.

ASPPA's proposal addresses both of these concerns.

Under ASPPA's proposal, the participants in the above examples would be able to receive benefits more equitably than would be permitted under the Proposed Regulations; essentially, the remainder of their benefits with an adjustment for "right of conversion." For example, the participant who was receiving the $100,000 annuity would be able to receive the adjusted remaining portion of his accrued benefit as a lump-sum, and the participant receiving the $80,000 benefit would be able to have his annual benefit increased from $80,000 to $100,000. Please see examples 1a and 1b (see Attachment) for an illustration of how we would address the situation in Example 1, above. Please see Example 2a for an illustration of how we would address the situation in Example 2, above.

Further Discussion of Other Topics

Right of Conversion

In Example 1 above, a participant was given the ability to convert future annuity payments to a lump-sum after the initial ASD. If the plan pays the participant a lump-sum equal to the present value of his remaining payments, the plan may be paying a benefit well in excess of the benefit he would have received had life annuity payments continued. The likelihood of receiving excess benefits would be especially great if the participant were in poor health at the time the conversion right from an annuity payment to a lump-sum was granted. The right of conversion removes, in large part, the life-contingent nature of annuity payments, in essence guaranteeing future payments even in the event of death. The value of this guarantee must be taken into account in evaluating the form of benefit payment and the IRC §415 limit.

Consider a plan that provides participants with the right to convert their benefit from a lifetime annuity to a lump-sum after the initial ASD. The conversion right makes this benefit inherently more valuable than a lifetime annuity alone. As a result, in determining the IRC §415 limit applicable to a conversion right payment stream, all benefit payments through the conversion should be considered as guaranteed by valuing the payment stream as a temporary annuity with a balloon payment. In situations in which the right to convert is added later, the benefit should be valued as a temporary life annuity with a guaranteed balloon payment.

In Example 1, the participant did not have a conversion right until age 75, when he retired. Thus, his ten years of annuity payment were truly life-contingent. Under ASPPA's proposal, the maximum lump-sum payable at age 75 would be the present value at age 65 of a life annuity of $100,000, reduced by the present value of the ten-year temporary life annuity of $100,000 (taking into account both interest and mortality), with the remainder brought forward with interest-only from ages 65 to 75. In essence, the IRC §415 limit does not contain a benefit of survivorship for the period from ages 65 to 75 for the portion of the benefit to be converted to a lump-sum.

If the plan in Example 1 allowed a participant to convert from a life annuity to a lump-sum at any time, or upon termination of employment following the beginning of payments while in service, then all of the payments under this stream become, in essence, guaranteed. Because there is no loss of risk at death, there is no benefit of survivorship for any of the payments. Thus, the maximum lump-sum payable at age 75 would be the present value at age 65 of a $100,000 life annuity, reduced by the present value of a ten-year temporary $100,000 annuity (without a mortality discount), with the remainder brought forward with interest-only from ages 65 to 75.

Interest Rates

In valuing prior distributions for a second ASD, the Proposed Regulations call for using the IRC §417(e) interest rate for the later ASD to revalue the initial distribution. The use of this rate adds some clarity to the calculations and handles situations when calculations from the original distributions are lost.

Unfortunately, using the IRC §417(e) approach will yield volatile results. For example, as the IRC §417(e) rate decreases, any prior benefit payments will represent a smaller and smaller accrued benefit, increasing the benefit to be provided by the plan. This increase, or "whipsaw," will occur at a time when the plan's benefit liabilities skyrocket as a result of declining rates, unnecessarily increasing a plan's liabilities and further interfering with its ability to be adequately funded.

If the IRC §417(e) rate increases, the resulting impact on benefits is even worse. In this situation, IRC §415 will force the current plan to reduce or eliminate the participant's benefit. This has the potential to create large surpluses in small plans that would eventually be subject to the draconian excise taxes on plan reversions.

The very presence of such volatility is undesirable from both planning and funding perspectives. ASPPA's offers the following suggestions to avoid this unnecessary volatility.

If the benefit payments from the earlier ASD were paid from the same plan, or from another existing plan of the same employer, the rate used to value the prior payments should be the rates actually applied at the earlier ASD. For prior distributions subject to IRC §417(e), this means that the interest rate basis in effect as of the original ASD would be maintained. This results in the offset to the current 415 limit being a constant annuity amount.

If the benefit payment from the earlier ASD was from another, no longer active, plan, prior distributions from that plan would be valued at an assumed rate. The assumed rate for prior annuity starting dates would be the lowest allowable rate for the prior ASD generally

- 5% for non-IRC §417(e) benefits;
- The greater of the applicable interest rate as of January 1 of the year containing the ASD and 5% for IRC §417(e) benefits with an ASD prior to 2004; and
- The greater of the applicable interest rate as of January 1 of the year containing the ASD and 5.5% for IRC §417(e) benefits with an ASD in 2004 and later.

Regulations would include a table specifying the rate to use for prior ASDs based on whether the form was subject to IRC §417(e) and the applicable interest rate as of January 1 of the year containing the ASD.

It is possible that records of long-ago distributions may not exist, even if the distribution was from a plan of the employer which remains active. In that case, the assumed rate noted above would be used to value the prior distribution. Admittedly, this approach subjects the calculation to anti-selection with respect to the location of records. The determination of the assumed rate, nevertheless, judges the benefit paid versus the maximum benefit allowable as of the ASD. Since IRC §415 is a limitation on the maximum benefit allowable, the use of these assumed rates, even on a so-called anti-selection basis, does not result in benefits larger than intended under the IRC and regulations.

Finally, while ASPPA strongly believes that interest rates applicable as of the original ASD should be recognized in determining the remaining portion of the 415 limit, ASPPA cannot stress enough the importance of stability in determining the remaining limit. Thus, if the rates as of the original ASD are not recognized in the calculation, it is crucial that the rate used is not variable. To that end, if the original ASD rates are to be ignored, ASPPA recommends that the assumed rate described above be used to value all prior distributions.

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These comments were prepared by ASPPA's Government Affairs Committee, and were primarily drafted by Thomas J. Finnegan, MSPA, CPC, QPA, and David M. Lipkin, MSPA. Please contact us if you have any comments or questions regarding the matters discussed above. Thank you for your consideration of these comments.

Sincerely,

/s/

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Attachment

Examples

Factors and assumptions

- Temporary Annuity Factor = 7.486 at age 65.
- Annual payments
- A mortality discount factor is recognized unless otherwise stated
- Assumptions – G94 mortality, 5.5% interest
- Assume 100% of pay limit is less than dollar limit

Example 1a

- Same facts as Example 1, above
- Plan pays a lump-sum at age 75 of $ 880,161
- This represents the present value of a $100,000 per year life annuity at age 75

Apply Step 1 – **at the original ASD, do both streams of payment satisfy IRC §415?**

- At age 65, what are the streams of payments?

- Stream A = temporary annuity of $100,000 per year from ages 65 to 75. Value = $748,584, at age 65

- Stream B = lump-sum payment of $880,161 at age 75. Value at age 65 (discounted with interest only) = $515,273

- Total Value at age 65 = $1,263,857

- At age 65, what is the IRC §415 limit?

- Value of $100,000 per year for life = $1,177,200, at age 65 (factor = 11.772)

Therefore, the value of Stream A plus the value of Stream B exceeds the IRC §415 limit at age 65, so the proposed amount of lump-sum is not available. Since Step 1 is not passed, we will not proceed with Step 2 in this example.

Example 1b

- Same facts as Example 1a, above, except that the plan pays a lump-sum at age 75 of $732,138

Apply Step 1 – **at the original ASD, do both streams of payment satisfy IRC §415?**

- At age 65, what are the streams of payments?

- Stream A = temporary annuity of $100,000 per year from ages 65 to 75. Value = $748,584, at age 65

- Stream B = lump-sum payment of $732,138 at age 75. Value (discounted with interest only) = $428,616

- Total Value at age 65 = $1,177,200

- At age 65, what is the IRC §415 limit?

- Value of $100,000 per year for life = $1,177,200, at age 65 (factor = 11.772)

Therefore, the value of Stream A plus the value of Stream B does not exceed the IRC §415 limit at age 65, so Step 1 is satisfied.

Apply Step 2 – **as of the second annuity starting date, do the prospective payments to be made satisfy IRC §415?**

- At age 75, the IRC §415 limit, based on a $100,000 life annuity, is $880,161 (factor = 8.802)
- The prospective payment as of that date is a lump-sum of $732,138
- Since the prospective payment has a smaller value than the IRC §415 limit, then Step 2 is also passed

Therefore, the proposed amount of lump-sum is available at age 75.

Example 2a

- Same facts as Example 2, above

Apply Step 1 – **at the original ASD, do both streams of payment satisfy IRC §415?**

- At age 65, what are the streams of payments?

- Stream A = temporary annuity of $80,000 per year from ages 65 to 75 Value = $598,867, at age 65

- Stream B = life annuity of $100,000 per year at age 75. Value at age 65 = $428,575 (factor = 4.286)

- Total Value at age 65 = $1,027,442

- At age 65, what is the IRC §415 limit?

- Value of $100,000 per year for life = $1,177,200, at age 65 (factor = 11.772)

Therefore, the value of Stream A plus the value of Stream B does not exceed the IRC §415 limit at age 65, so Step 1 is satisfied.

Apply Step 2 – **as of the second annuity starting date, do the prospective payments to be made satisfy IRC §415?**

- At age 75, the IRC §415 limit is a $100,000 life annuity
- The prospective payment stream as of that date is a life annuity of $100,000 per year
- Since the prospective payments do not exceed the 415 limit, then Step 2 is also passed

Therefore, the proposed amount of life annuity is available at age 75.

Example 3

Participant A has a high three-year average compensation of $100,000 per year, and commences annual income at age 65 in the amount of $1,000 per year. Since the plan's benefit has been much smaller than the available IRC §415 limit, the plan now wishes to increase benefits at age 75 to $110,000 per year.

Apply Step 1 – **at the original ASD, do both streams of payment satisfy IRC §415?**

- At age 65, what are the streams of payments?

- Stream A = temporary annuity of $1,000 per year from ages 65 to 75.

Value = $7,486 at age 65

- Stream B = life annuity of $110,000 per year at age 75. This has a value at age 65 of $471,433

- Total Value at age 65 = $478,919

- At age 65, what is the IRC §415 limit?

- Value of $100,000 per year for life = $1,177,200, at age 65 (factor = 11.772)

Therefore, the value of Stream A plus the value of Stream B does not exceed the IRC §415 limit at age 65, so Step 1 is satisfied.

Apply Step 2 – **as of the second annuity starting date, do the prospective payments to be made satisfy IRC §415?**

- At age 75, the IRC §415 limit is a $100,000 life annuity
- The prospective payment as of that date is a life annuity of $ 110,000 per year
- Since the prospective payments are larger than the IRC §415 limit, then Step 2 fails

Therefore, the proposed amount of life annuity is not available at age 75.