



## RETIREMENT SERVICES DIVISION MEMORANDUM 2020-04

June 30, 2020

**ATTENTION:** State Agency Retirement Subject Matter Experts

**SUBJECT:** SUMMARY OF AGREEMENT WITH IRS REGARDING APPLICATION OF LIMITS ON RETIREMENT INCOME TO SERS RETIREMENT POPULATIONS

### I. Introduction

The U.S. Internal Revenue Code includes rules that apply to qualified defined benefit plans, such as the Connecticut State Employees Retirement System. Two of those rules impose limits on the amount of retirement income which may be paid in any year to a participant in a qualified plan.

In April 2020, in a document that approved what is known as a “voluntary compliance program,” the Internal Revenue Service ruled that SERS must take certain steps to be in full compliance with those rules. In some cases, this ruling will cause the future benefits of a SERS retiree to be reduced. In others, the member’s benefits will be increased—both prospectively, and retroactively.

In a very few cases, it is possible that a retiree *both* will have his or her future benefits reduced *and* will also be responsible for reimbursing SERS for past overpayments. At this time, however, we have not found any cases in which such reimbursement will be necessary.

The rules that make these actions necessary can be difficult to understand, and they produce outcomes that may be difficult to explain. Under these rules, two retirees with very similar work histories might be eligible for substantially different amounts of pension, based only on the year in which each retiree began participating in SERS. For this reason, we anticipate that the action which the IRS has required will generate many questions from SERS members.

This memorandum will explain the relevant rules, the background of the IRS’s ruling, and the effect that ruling will have on different SERS populations.

## **II. Background of the VCP Approval**

### **A. Limits on Retirement Income under Federal Tax Laws**

The State Employees Retirement System (“SERS”) is a qualified retirement plan, within the meaning of Section 401(a) of the Internal Revenue Code (the “Code”). A qualified plan provides tax advantages to its members, such as allowing members to make retirement contributions on a pre-tax basis. To maintain its qualified status, SERS must comply with certain requirements of the Code. Two of those requirements limit the amount of retirement income that a member may receive in any given year.

Section 415(b) of the Code limits members’ annual retirement income directly (the “415(b) Limit”). The limit is tied to the employee’s age at retirement: the younger the retiree, the lower the cap. That age adjustment does not apply to certain employees with public safety responsibilities, such as police officers and firefighters. However, the public safety exception is *not* available to other hazardous duty employees, such as correction officers.

Another section of the Code, Section 401(a)(17), limits retirement income *indirectly*. It places a cap on the amount of salary earned during any one of the employee’s working years that may be taken into account when calculating the amount of the employee’s pension (the “401(a)(17) Limit”).

Both the 415(b) Limit and the 401(a) Limit are explained in greater detail below.

### **B. Past Problems Applying the Limits**

Before January 1, 2011, the Retirement Services Division (the “Division”) did not generally apply these two limits when calculating pension benefits. Even after that date, questions remained about how to apply those limits to various members of SERS.

To resolve this uncertainty, the State Employees Retirement Commission (the “Commission”), through its tax counsel, filed a request under the voluntary correction program (“VCP”) to the U.S. Internal Revenue Service (“IRS”). The VCP request addressed, among other issues, the question of how SERS should apply the 415(b) Limit and the 401(a)(17) Limit. In a letter dated April 30, 2020 (the “VCP Approval”), the IRS approved the proposed VCP.

### **C. Terms of the VCP Approval**

Pursuant to that approval, SERS will have until September 27, 2020, to implement certain corrections. Those corrections consist primarily of (i) imposing annual benefit limits on retirees to whom they have not previously been applied, and (ii) paying additional benefits to retirees to whom the limits have been applied, but who are exempt from the limits under the VCP Approval.

One effect of the VCP Approval is that a portion of some members’ past salary or payments must now be treated as pensionable earnings for the first time. Those members will be required to pay additional mandatory contributions for SERS retirement benefits and/or other post-employment benefits (“OPEB”). Those additional contributions will be addressed in a separate memorandum.

The necessity and amount of these corrections will depend on various factors. Among other things, the VCP Approval provides:

- The 415(b) Limit will not be applied to employees who became members of their current retirement plan in SERS before January 1, 1990.
- The 401(a)(17) Limit will not be applied to employees who became members of their current retirement plan in SERS before July 1, 1996.
- For SERS members who retired before January 1, 2011 and who were not subject to both exceptions noted above, the two limits will be applied only *prospectively*.

These rules affect the members of SERS in different ways. Some retired members whose retirement income has previously been reduced by either the 415(b) Limit or the 401(a)(17) limit will be entitled to additional payments, because, under these rules, they *should have* been exempted from the limits, based on the date when they joined their current SERS plans. Other members whose retirement income has previously been subjected to one of these limits will *not* receive any additional payment, because the relevant “grandfathering” provisions do not apply to them.

Certain other retired members whose pensions have *not* been reduced by either limit will now be subjected to either the 415(b) Limit or the 401(a)(17) Limit. Under the VCP Approval, any such member will have the limit applied to his or her future retirement income. Members who retired after January 1, 2011, could also be responsible for reimbursing past overpayments; however, as discussed below, we have not yet identified any members who are in this position.

### **III. Summary of Relevant Limiting Provisions**

SERS is a defined benefit retirement plan. This means that members who satisfy the minimum age and service requirements are eligible to receive lifetime payments of retirement income, based on the member’s age, credited service, and average salary.

Sections 415(b) and 401(a)(17) of the Code both restrict the amount that may be paid to a retired member of a qualified defined benefit plan in any given year. If a plan fails to apply those limits, it risks being declared a nonqualified plan. In that case, the plan and its members would be ineligible for tax-favored treatment under the Code.

#### **A. The 415(b) Limit**

Section 415(b) of the Code limits the amount that may be paid as a benefit by a qualified defined benefit plan in any given year. The IRS adjusts this maximum benefit every year. For the plan year commencing July 1, 2020, the annual benefit under a defined benefit plan at normal retirement age (age 62) may not exceed \$230,000.

##### **1. Age Adjustments to the 415(b) Limit**

The \$230,000 maximum is an *unadjusted* limit; it applies to any retiree who begins to collect pension benefits at age 62 or older. For plan members who collect pension benefits before age 62, IRS regulations require that the maximum benefit be *reduced* to an age-adjusted, actuarial equivalent of that amount. In other words, the amount of the 415(b) Limit assumes that normal retirement occurs at age 62 or later. The maximum benefit allowed by the 415(b) Limit gets progressively lower for each year before age 62 at which an employee retires.

For example, while the 415(b) Limit for a 62-year-old retiring in 2020 is \$230,000.00, as noted above, the age-adjusted limit for an individual retiring in 2020 at exactly 40 years old is only \$59,243.00.

In SERS, this age adjustment is most often applied to hazardous duty members who retire before age 62.

A chart listing the various age-adjusted 415(b) Limits for individuals that retire in 2020 is available on the OSC website: <https://www.osc.ct.gov/rbsd/audit/2020Section415Limits.pdf>.

## **2. The Public Safety Exception to the 415(b) Limit**

The age adjustment of the 415(b) Limit does not apply to certain government employees who satisfy two conditions. An employee is exempt from this adjustment (i) if he or she has been an employee of a police or fire department, or of certain other government agencies dedicated to public safety, and (ii) if the calculation of his or her retirement benefit is based on at least fifteen (15) years of full-time employment with such an agency.

This exception has been a point of contention, because (for example) it allows certain State Police officers to retire with a full, hazardous duty SERS pension, while a correction officer with a similar employment history will be subject to an age-adjusted 415(b) Limit. In July 2012, the Retirement Commission sought to rectify this disparity by seeking a Private Letter ruling from the IRS, which would have extended the Public Safety Exception to Correction Officers. In August 2013, the IRS denied that request.

## **3. “Grandfathering”**

Code Sections 415(b)(10)(A) and (B) establish a “special rule” for governmental plans like SERS. They state, in effect, that the 415(b) Limit will not reduce the annual retirement income of employees who became members of such a plan before January 1, 1990.

### **B. The 401(a)(17) Limit**

Section 401(a)(17) of the Code limits the amount of annual compensation that may be included in the calculation of a member’s retirement benefit. The annual compensation limit is determined annually. For 2020 the plan year commencing July 1, 2020, the limit is \$285,000.

For example: If a member’s future retirement income will be based on the average of the salary that the member received during his or her three highest-paid years; if one of those years turns out to be 2020; and if the member will have been paid \$300,000 in 2020; then, the member’s retirement income will be calculated as if his or her 2020 salary was only \$285,000.

### **1. “Grandfathering”**

The Omnibus Budget Reconciliation Act of 1993 (“OBRA 1993”) created a “special transition rule” for governmental plans—a rule that creates exemptions from the 401(a)(17) Limit. As interpreted in the VCP Approval, this exemption applies to any member of SERS who joined his or her current plan before July 1, 1996.

## **IV. The VCP Approval**

The VCP Approval provides that SERS must apply both the 415(b) Limit and the 401(a)(17) Limit, and that it must do so both prospectively and retroactively. However, as noted above, it also creates three broad exceptions:

- The 415(b) Limit will not be applied to employees who became members of their current retirement plan in SERS before January 1, 1990.
- The 401(a)(17) Limit will not be applied to employees who became members of their current retirement plan in SERS before July 1, 1996.
- For SERS members who retired before January 1, 2011 and who were not subject to both of the exceptions noted above, either or both of the limits will be applied, as appropriate, but they will be applied only prospectively.

These exceptions affect specific groups of SERS retirees in different ways. In some cases, the amount of a member's past and/or future retirement benefits will have to be adjusted. Those adjustments are discussed below.

### **A. Retirees Whose Benefits Exceeded the 415(b) Limit, But Were Not Reduced**

#### **1. Members who Joined Their Current Plan Before January 1, 1990**

Any retiree or current employee who joined the SERS retirement plan of which he or she is currently a member before January 1, 1990, is not subject to the 415(b) Limit. No change will be made to such retirees' benefits, even if those benefits exceed or have exceeded the 415(b) Limit.

#### **2. Members who Joined Their Current Plan on or After January 1, 1990, and who Retired Before January 1, 2011**

If a member joined his or her current retirement plan on or after January 1, 1990; if the member retired before January 1, 2011; and if the member's retirement income exceeds and/or has exceeded the 415(b) Limit; then that member's *future* retirement income will be reduced to the level that limit requires. Any *past* payments in excess of the limits will be unaffected by the VCP Approval.

#### **3. Members who Joined Their Current Plan on or After January 1, 1990, and who Retired After January 1, 2011**

If a member joined his or her current retirement plan on or after January 1, 1990; if the member retires or retired after January 1, 2011; and if the member's retirement income exceeds the 415(b) Limit; then that member's *future* retirement income will be reduced to the level that limit requires.

In addition, if a member in this category received *past* retirement payments that exceeded the 415(b) Limit, then the member would have to reimburse SERS for the amount of the overpayments he or she received. Because SERS began applying the 415(b) Limit in 2011, however, the Retirement Services Division has not yet identified any member who has been overpaid in this way.

**B. Retirees who Are Exempt from the 415(b) Limit under the VCP Approval, but to Whom the Limit was Applied**

The VCP Approval exempts certain SERS retirees from the 415(b) Limit, because the retirees joined their current retirement plan before January 1, 1990. Some of these retirees have had their benefits reduced under § 415(b).

Any member who joined his or her plan before January 1, 1990, and whose retirement income has been reduced pursuant to the 415(b) Limit, will receive a lump sum payment of the total amount that was withheld from his or her retirement income because of that limit. Because such members' exemption from the limit became effective only when the IRS issued the VCP Approval in 2020, no interest will be added to this lump sum payment.

Additionally, the member's *future* retirement payments will be *increased*, because the 415(b) Limit will no longer be applied to retirees that joined their current retirement plan before January 1, 1990.

**C. Retirees to Whom the 415(b) Limit was Correctly Applied**

SERS began applying the 415(b) Limit uniformly in 2011. Consequently, *most* members of SERS will not require any adjustment of retirement benefits as a result of the VCP Approval.

**D. Retirees Whose Benefits Exceeded the 401(a)(17) Limit, But Were Not Reduced**

**1. Members who Joined Their Current Plan before July 1, 1996**

Any retiree or current employee who joined the SERS retirement plan of which he or she is currently a member before July 1, 1996, is not subject to the 401(a)(17) Limit. No change will be made to such retirees' benefits, even if those benefits were based on compensation that exceeded the 401(a)(17) Limit.

**2. Members who Joined Their Current Plan on or After July 1, 1996, and who Retired Before January 1, 2011**

If a member joined his or her current retirement plan on or after July 1, 1996; if the member retired before January 1, 2011; and if the member's retirement income was based on an amount of compensation that exceeded the 401(a)(17) Limit; then that member's *future* retirement income will be reduced to the level that the limit requires. Any *past* payments in excess of the limits will be unaffected by the VCP Approval.

**3. Members who Joined Their Current Plan on or After July 1, 1996, and who Retired or Retire After January 1, 2011**

If a member joined his or her current retirement plan on or after July 1, 1996; if the member retires or retired after January 1, 2011; and if the member's retirement income was based on an amount of compensation that exceeded the 401(a)(17) Limit; then that member's *future* retirement income will be reduced to the level that limit requires.

An additional adjustment would have to be made if the 401(a)(17) Limit has not been applied to one or more of the member's *past* retirement payments. Such a member would have to reimburse SERS for the amount of any past overpayments. Because SERS began applying the 401(a)(17) Limit in 2011, however, the Retirement Services Division has not yet identified any member who has been overpaid in this way.

#### **4. Members who will be Required to Make Additional Contributions**

As a result of the VCP Approval, certain retirees and active members to whom the 401(a)(17) Limit has been applied will be exempted from that limit. In some cases, this will mean that a portion of the member's salary or payments in excess of the 401(a)(17) limit will now be treated as pensionable income. Because of this change, an adjustment will have to be made to the member's contributions for SERS retirement benefits and for his or her OPEB contributions.

Those adjustments and the prospective contribution payments for high wage earners will be discussed in a future memorandum to be issued jointly by the Retirement Services Division, the Active and Retirement Payroll Division, and the Healthcare Benefits and Policy Division.

##### **E. Retirees who Are Exempt from the 401(a)(17) Limit under the VCP Approval, but to Whom the Limit was Applied**

The VCP Approval exempts certain SERS retirees from the 401(a)(17) Limit, because they joined their current retirement plan before July 1, 1996. Some of these retirees are members whose retirement benefits have previously been reduced under § 401(a)(17).

Any member who joined his or her plan before July 1, 1996, and whose retirement income has been reduced as a result of the 401(a)(17) Limit, will receive a lump sum payment of the total amount that was withheld from his or her retirement income because of that limit. Because such members' exemption from the limit became effective only when the IRS issued the VCP Approval in 2020, no interest will be added to this lump sum payment.

Additionally, the *future* retirement payments of any such member will be *increased*, because the 401(a)(17) Limit will no longer be applied to SERS members that joined their current retirement plan before July 1, 1996.

##### **F. Retirees to whom the 401(a)(17) Limit has been Correctly Applied**

As is the case with the 415(b) Limit, it bears repeating that the 401(a)(17) Limit has been applied correctly to most SERS retirees since January 1, 2011. Most SERS members will be unaffected by the VCP Approval.

#### **IV. Conclusion**

The implementation of the corrections that are required under the VCP Approval will place a heavy burden on some SERS members. As noted above, the 415(b) Limit severely reduces the statutory benefit payable to members who retired at a relatively young age. Some of those members will have colleagues who have a similar employment history, but who will suffer *no* reduction, simply because they were hired a few years earlier.

For this reason, it will be important for you to be able to explain that these distinctions are based in federal law, over which SERS has no control. Furthermore, compliance with that federal law is essential to maintaining the status of SERS as a qualified retirement plan—a status that confers important benefits on *every* member.

As always, we thank you for your cooperation.

If you have any questions concerning this matter, please contact the undersigned at (860) 702-3443.

Very truly yours,

BY:

John W. Herrington, Director  
Retirement Services Division