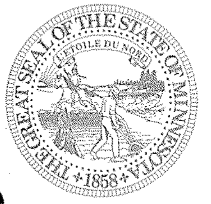


**S.F. 70**
(Betzold)

**H.F. 40**
(Smith)

## Executive Summary of Commission Staff Materials

*Affected Pension Plan(s):* MSRS, PERA, TRA
*Relevant Provisions of Law:* Minnesota Statutes 2004, Section 11A.18, Subdivision 9
*General Nature of Proposal:* Creating a Five Percent Cap on Annual Increases form the State Board of Investment Post Fund
*Date of Summary:* January 13, 2006

## Specific Proposed Change(s)

- S.F. 70 (Betzold); H.F. 40 (Smith) would cap the increase payable from the State Board of Investment Post Retirement Investment Fund at five percent in any given year.

## Policy Issues Raised by the Proposed Legislation

1. Extent of support by interested parties.
2. Existing retirees benefit takeaway or deferral issue, possible litigation.
3. Implications of successful litigation.
4. Question of consistency with federal regulations.
5. Temporary nature of the proposed solution.
6. Inconsistency with the Commission's Principles of Pension Policy.
7. Alternative of a study.
8. Proper cap level.
9. Treatment of excess.

## Potential Amendments

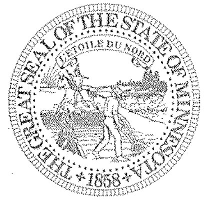
LCPR05-045 is a technical amendment to reference the actuary retained jointly by the major pension fund administrations.

LCPR05-046 changes the cap from five percent to a percent to be specified.

LCPR05-047 specifies any excess reserves due to the cap are to be allocated to the next year.

LCPR05-048 (alternative to LCPR05-047) specifies any excess reserves due to the cap are to be allocated in equal amounts to each of the next four years.

State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT



TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director EB

RE: S.F. 70 (Betzold); H.F. 40 (Smith): MSRS, PERA, TRA: Creating a Five Percent Cap on Annual Increases from the State Board of Investment Post Fund

DATE: January 12, 2006

Summary of S.F. 70 (Betzold); H.F. 40 (Smith)

S.F. 70 (Betzold); H.F. 40 (Smith) would cap the increase payable from the State Board of Investment Post Retirement Investment Fund at five percent in any given year.

Background Information on Participating Plans

For decades, disabilitants, retirees, and survivors from the various defined benefit pension funds administered by the Minnesota State Retirement System (MSRS), the Public Employees Retirement Association (PERA), and the Teachers Retirement Association (TRA), have received periodic increases during retirement generated by the investment operation of the current State Board of Investment (SBI) Post Retirement Fund or its various predecessors. The MSRS plans which participate in the Post Fund are MSRS-General, MSRS-Correctional, the Legislators Retirement Plan, the State Patrol Plan, and the Judges Retirement Plan. Retirees from the MSRS-Unclassified Plan, a defined contribution plan, are also authorized to transfer the reserves for their annuities to the Post Fund and participate in that program. The PERA plans which participate in the Post Fund are PERA-General, the PERA Police and Fire Retirement Plan, and the PERA Local Correctional Retirement Plan. All TRA retirees, survivors, and disabilitants also participate in the Post Fund.

Background on State Board of Investment Post-Retirement Adjustment Procedures

Minnesota has provided post-retirement adjustments based on a measure of investment income or return since 1970, first as the Minnesota Adjustable Fixed Benefit Fund and then as the current Minnesota Post Retirement Investment Fund (MPRIF, or Post Fund).

The Minnesota Adjustable Fixed Benefit Fund operated from 1970 through 1980 until it was replaced by the Post Fund. When the Minnesota Adjustable Fixed Benefit Fund was started, the actuarial reserves for retirees from the major statewide pension plans were transferred to the Minnesota Adjustable Fixed Benefit Fund. Those assets included assets for MERF retirees. In 1980 or 1981, a separate Post Fund was created for the Minneapolis Employees Retirement Fund and MERF began managing the assets of its retirees. The MERF post-retirement adjustment mechanism was designed to duplicate the statewide mechanism.

The Minnesota Adjustable Fixed Benefit Fund and its successor, the Post Fund, both have serious flaws if the intent is to keep retirees whole. The systems were not designed to match inflation. They either overcompensate for the eroding power of inflation, or they under-compensate. The post-retirement adjustment mechanisms the state has used to date are dependent upon investment income or investment returns to generate the needed increase, and the investment markets do not move in lockstep with inflation. In some periods retirees received little or no increase despite high inflation, while at other times very high benefit increases were provided during low inflation periods.

a. The Minnesota Adjustable Fixed Benefit Fund. At least in theory, the Minnesota Adjustable Fixed Benefit Fund had a post-retirement adjustment process that allowed retiree benefits to increase or decrease during retirement, depending upon investment results, although the benefit amount was not permitted to go below that received at the time of retirement. In practice, the Minnesota Adjustable Fixed Benefit Fund operated differently. By amending the benefit floor language, the Legislature never permitted benefits to fall below the most recent levels.

   Each retirement fund taking part in the Minnesota Adjustable Fixed Benefit Fund transferred sufficient reserves to permit level annuities to be paid to retirees, providing the fund continued to earn at least the actuarial interest requirement. The Minnesota Adjustable Fixed Benefit Fund annuities could be

revised through an adjustment mechanism relying on a two-year average total rate of return measure. The use of averaging added some stability. The total rate of return included dividends, interest, and realized and unrealized gains or losses. Annually, a "benefit adjustment factor" was computed. This was calculated by dividing one plus a two-year average total rate of return, by one plus the actuarial return. If the fund was not meeting the actuarial investment earnings requirement, the ratio was less than one. If the return equaled the actuarial return, the ratio was equal to 1. If the returns exceeded the actuarial return, the ratio would be greater than one. The law stated that benefits could be increased if the benefit adjustment factor was greater than 1.02, providing that certain additional requirements were met. If the benefit adjustment factor was less than .98, a benefit decrease was required, but at no time could the retirement payments drop below the level received at the date of retirement.

The benefit increases actually granted through the Minnesota Adjustable Fixed Benefit Fund were minimal, due in part to the poor investment climate during the 1970's and to the annuity stabilization reserve that was part of the Minnesota Adjustable Fixed Benefit Fund adjustment process. Benefit increases above four percent could not be paid unless the annuity stabilization reserve contained enough assets to cover 15 percent of the past year's benefit payments. If the reserve was insufficient, part of the new investment earnings were added to the reserve, rather than being paid out as benefits. Benefit increases above four percent required correspondingly higher annuity reserves.

b. The Minnesota Post Retirement Investment Fund (Post Fund) – 1980. In 1980, the Legislature established the Minnesota Post Retirement Investment Fund (Post Fund), the successor to the Minnesota Adjustable Fixed Benefit Fund. The Legislature has modified the operation of the Post Fund on a few occasions, often to address some evident flaw. Like the Minnesota Adjustable Fixed Benefit Fund, the Post Fund included an automatic adjustment mechanism intended to provide benefit adjustments to help offset, to some degree, increases in living costs. One difference was that while the old system based adjustments on total return, including unrealized gains, the original version of the Post Fund provided adjustments based solely on realized income. Another difference was that the Post Fund contained no provisions for reducing benefit levels when returns were low. Third, the original Post Fund based adjustments on a single year's realized investment return, rather than using a multi-year period.

To determine adjustments, at the end of each fiscal year (June 30) the required reserves were calculated. The required reserves were the assets needed to meet the present stream of annuity payments to be paid to retirees over time, providing that the assets earned at least five percent, which was the Post Fund actuarial interest requirement at that time. The total reserves were multiplied by 1.05 to determine the amount of investment income needed to sustain the current benefit level. By subtracting this amount from total realized investment earnings, excess investment earnings are obtained--earnings which can be used to create a permanent increase in the benefits of retirees. The fiscal year information is used to determine the amount of increase, if any, payable the next January 1st, the effective date of any benefit change. To determine benefit increases payable as of January 1st, the excess investment income and the required reserves must be projected forward to that date. This requires increasing the excess investment income by 2.5 percent, the return which those funds must earn for the six month period in order to meet actuarial requirements, and estimating the total required reserves on January 1st for those eligible for a post-retirement adjustment.

c. The Minnesota Post Retirement Investment Fund (Post Fund) – 1992. Significant changes in the Post Fund occurred in 1992 (Laws 1992, Chapter 530), as follows:

1. *Nature of Post-Retirement Increases*. Post-retirement increases would be based on total investment performance, not just realized gains, and for the most recent five-year period, rather than for a single year;
2. *Inflation Match Component*. An annual post-retirement increase matching inflation, but not to exceed 3.5 percent, was created; and
3. *Additional Investment-Based Increase*. An additional investment-performance based increase was permitted based on investment performance in excess of 8.5 percent total returns over five-year periods.

To demonstrate how the Post Fund automatic post-retirement increase procedure worked, at least in good investment times, assume the Post Fund's total return is greater than 8.5 percent. To determine the increase payable, SBI first determined the total required reserves needed to sustain the current benefit level. To support that level, the reserves need to earn the actuarial rate of return for the Post

Fund, which was five percent. The total amount needed to sustain the existing benefits is computed by multiplying the reserves by 1.05. Paying the inflation match up to 3.5 percent required additional reserves. If inflation as measured by changes in the Consumer Price Index was 3.5 percent, then the Post Fund would need to earn a return of 8.5 percent to cover the inflation match. (A return of five percent is needed just to sustain the existing benefit level, and an additional return of 3.5 percent, or a total of 8.5 percent, was needed to cover the inflation match component.) If the Post Fund's total return was in excess of 8.5 percent, then there are some additional assets generated through the investments which can be used to provide further investment-based post-retirement adjustments. To determine this last component, the money (assets) representing this additional return (amounts above that necessary to sustain the present benefit level and to cover the inflation match) is allocated in equal proportion to five accounts representing the current year and the following four years. The amount in the current year's account is the sum of this new allocated amount and all amounts that were added in the past by the operation of this allocation process. SBI then examines the account for the current year and computes how much of a benefit increase, expressed as a percentage, can be sustained by those reserves. This percentage is then added to the inflation match to determine the total percent increase provided to the Post Fund annuities.

The use of five (five-year) accounts for accumulating any excess reserves (the current year plus the next four), creates a form of averaging or smoothing. A very large return in a single year will not be all paid out to retirees in a single year; some of it is allocated to future years, helping to provide increases despite weaker investment returns. However, if there is a string of very good investment years, a prolonged period of very high benefit adjustments could occur. This did occur in the late 1990s.

d. The Minnesota Post Retirement Investment Fund (Post Fund) – 1997. The next significant adjustment in the Post Fund occurred in 1997. The inflation match was revised downward to 2.5 percent rather than 3.5 percent, and at the same time the Post Fund investment return assumption was revised from five percent to six percent.

The revised Post Fund investment return assumption was part of a package to increase benefits at the time of retirement. The benefit improvement as it applied to the SBI-invested plans increased the accrual rates for all defined benefit MSRS, PERA, and TRA plans participating in the Post Fund. In part this was financed by the revised Post Fund investment return assumption. Fewer reserves are needed to support any given annuity if the assets are assumed to earn six percent prior to payout rather than five percent. The released reserves can be used to cover higher benefits at the time of retirement. But the six percent return requirement, rather than five percent, leaves less of a margin between the Post Fund investment return assumption and the true long-term expected annual rate of return, which is 8.5 percent. The inflation match was reduced from 3.5 percent to 2.5 percent to compensate. In effect, a higher benefit at the time of retirement was traded for approximately one percent per year lower Post Fund adjustments. This was deemed acceptable by legislators because of the very high Post Fund adjustments that were occurring. They were excessive relative to inflation. Thus, reducing them by one percent seems to be a fairly painless tradeoff.

Post-Retirement Policy: Discussion of Post Fund Changes

Public sector retirees, like any retirees, have a desire to be kept whole. Inflation erodes purchasing power unless benefits are adjusted to compensate. A problem for public employers is that guaranteeing that retirees will be kept whole, or at least will not suffer serious erosion of purchasing power over time, can create liabilities. For decades, the Executive Branch and the Legislature have not been willing to take on these liabilities, at least not explicitly. At the same time, they face pressure from retirees to provide some form of adequate pension adjustments after retirement.

In response to this pressure, a somewhat unusual structure has been created. Various defined contribution notions were layered on top of the defined benefit plans. Prior to retirement, workers are in defined benefit pension plans, with the benefit at the time of retirement determined by formulas in law typically based on the member's high-five average salary, the years of covered service, and the accrual rate (the proportion of the high-five average salary which the individual receives in retirement per year of service). At the time of retirement, this is transformed into a structure with defined contribution plan elements. Under the Post Fund, the initial benefit level and the reserves needed to support that level are known; what is not known are the benefit increases during retirement. They will be determined solely by the investment performance of the Post Fund over time. Since investment market returns and inflation are not highly correlated, sometimes the adjustments failed to keep the retirees whole, leading to pressure to revise the system and/or provide some form of ad hoc adjustment to allow the retirees to catch up for past

losses in purchasing power. At other times, increases have been excessive, leading to problems of windfalls for some groups, while other groups feel shortchanged.

The original Minnesota Adjustable Fixed Benefit Fund had no provision to provide automatic increases for inflation, and its investment-return-based adjustments were doomed by bad investment markets during the 1970s. Inflation was high during this decade, exceeding ten percent at times, while the Minnesota Adjustable Fixed Benefit Fund provided little increase or, in some cases, no increase.

In response to these deficiencies, the Minnesota Post Retirement Investment Fund, or Post Fund, was created in 1980. One feature of this early Post Fund, which seems odd in retrospect, was basing adjustments solely on realized income rather than on total return. Presumably, this was in response to the 1970s, when equity markets were weak and erratic, in some years having strong negative returns. The new system would considerably downplay the role of equities. Therefore, a large drop in the value of equities would not influence the post-retirement adjustment unless the stocks were sold creating a recognized loss. Given this emphasis on realized income, SBI invested the Post Fund heavily in bonds. The Minnesota Adjustable Fixed Benefit Fund had based adjustments on two years of investment returns, while the original Post Fund that replaced it used only one year of investment results. That lack of any averaging is another feature that now seems odd. Perhaps it was thought that averaging would not be needed if bond returns were sufficiently stable.

During much of the 1980s, the Post Fund provided generous increases for retirees, considerably in excess of inflation. In part this was due to good investment returns in that decade for both stocks and bonds. Specific actions by the Federal Reserve may also have contributed. The Federal Reserve was concerned about levels of inflation during the 1980s and in part of this decade took action to cool the economy to lessen inflationary pressure. Interest rates were sharply increased to reduce investments and borrowing. If the SBI was successful in tapping into those high rates, that could provide high bond yields.

Despite the success during the 1980s, by the late in that decade SBI had concerns about the Post Fund's future. The Post Fund of the 1980s would not provide the yields that were desired in a low interest rate environment, a change which sooner or later must occur. Diversifying back into stock would further lower the fund's yield, because stocks provide very little yield. Most of the return to stock is due to the growth in the stock portfolio's value through capital gains, but these gains could not be recognized and used in the post-retirement adjustment unless the stock was sold. SBI also recognized that a Post Fund dominated by bonds had a lower total return than a portfolio with a reasonably high stock allocation. This meant that the Post Fund would be better off in the longer run if it were invested with a large stock allocation. There would be more assets which could be used to lower the cost of the system or provide more increases for retirees. But moving to stock could not occur in a system where the post-retirement increases were based on yield. It would be necessary to change back to a total return–based system, and also to go back to some form of multi-year averaging. Moving to stocks might raise the return, but the portfolio's return is likely to be less consistent over time than bond yields.

These concerns lead to the 1992 changes in the Post Fund's operations, and to considerable changes in its asset mix. The portfolio largely was shifted out of bonds to a portfolio dominated by domestic stock, foreign stock, and other equity investments. The Post Fund law was revised to provide post-retirement increases based on total investment performance rather than realized gains, and based on a five-year period rather than for a single year. An inflation match was created, not to exceed 3.5 percent, plus an additional increase based on investment performance in excess of 8.5 percent total returns over five-year periods.

From a policy standpoint, the inflation match is an important and desirable feature of this system. This was the first time that an inflation match had been included in the post-retirement adjustment system. *The Commission's Principles of Pension Policy states that benefit levels should be adequate at the time of retirement and should be kept adequate by adjusting the benefit to compensate for the rate of inflation, as measured by a valid economic indicator*. The Post Fund as revised in 1992 created an inflation match, although that match was capped. If inflation was higher than 3.5 percent, individuals would be kept whole only if investment returns were sufficient to provide a high enough additional investment return-based benefit.

The inflation match within the Post Fund adjustment mechanism is paid for by investment returns. Investment performance above five percent and under 8.5 percent covers the inflation match. If the returns are sufficient to cover or more than cover the cost of the inflation match, then there are some surplus assets to add to the five year accounts discussed earlier, used to determine whether further

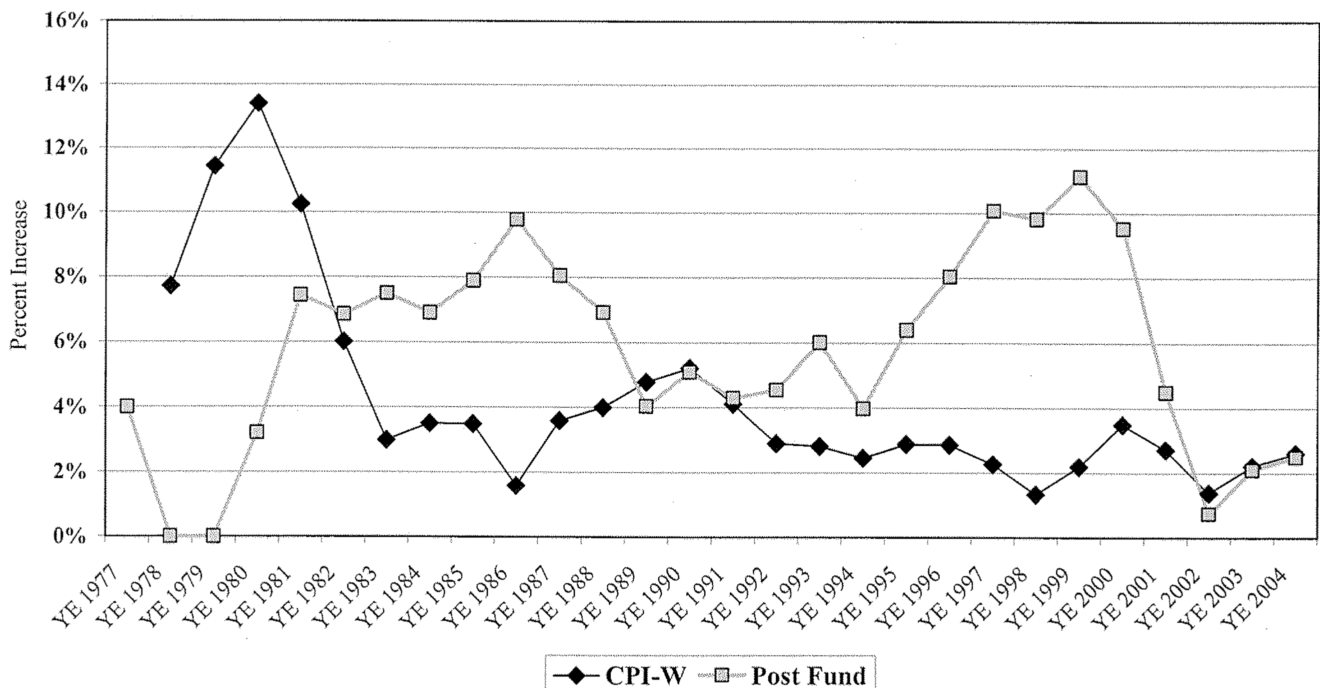
investment-performance based increases may be paid. If the return is not sufficient to cover the inflation match, the shortfall is added to the five yearly accounts discussed previously as a negative amount, which must be repaid before any money is available for additional investment based post-retirement adjustments.

In 1997, the Post Fund was again revised to use a six percent Post Fund investment return assumption rather than five percent, and the inflation match was decreased from 3.5 percent to 2.5 percent. As mentioned previously, the change in the investment return assumption helped to finance an increase in benefits at the time of retirement. Unfortunately, it came at the expense of lowering the inflation match, which seems inconsistent with the Commission's Policy Statement regarding postretirement adjustments, and which was perhaps the most desirable feature added to the Post Fund operation several years earlier, in 1992.

Post-Retirement Increases Compared to Inflation

The chart below compares total post-retirement increases (provided by the Minnesota Adjustable Fixed Benefit Fund in 1978 and 1979, and by the Post Fund thereafter) with inflation, as measured by the Consumer Price Index (CPI) for Urban Wage Earners and Clerical Workers (CPI-W), which is produced by the U.S. Department of Labor Bureau of Labor Statistics. The inflation rates are based on calendar years. The Post Fund increases are based on July 1 fiscal year periods, but are payable beginning the next January 1. The inflation match contained within a Post Fund increase (since the inflation match component was added in 1992) is also based on a fiscal year rather than a calendar year. This might create some differences between the inflation rate line and the Post Fund line in the chart. One would expect, however, that if the post-retirement increases were designed to keep retirees whole, the two lines would be very similar, although perhaps with a partial- or full-year delay. *What the chart reveals, however, is that the inflation rate and the total Post Fund adjustment are rarely similar.* In 1982 and earlier, inflation was much higher than the adjustment. In 1979 and 1980, no benefit adjustment occurred despite inflation of nine percent in one year and over thirteen percent the next. This was followed by a prolonged period from 1983 to 2002 where the Post Fund adjustments were in excess of inflation, often by considerable amounts, except for a brief period in the early 1990s. *On whole, for the last two decades, the Post Fund adjustments greatly exceeded inflation compared to changes in consumer prices.* This provided a considerable windfall to these retiree groups. Assets used to support the annuities of these retiree groups are not available for a rainy day, to provide needed adjustments when recent investment returns are insufficient to provide the added reserves that are needed.

**Minnesota Post Fund Post-Retirement Increases**
**vs.**
**Consumer Price Index for Urban Wage Earners and Clerical Workers**




The effects of these Post Fund increases compared to inflation can also be examined by reviewing the increases over time for a few groups of retirees. For individuals who retired in 1980, a basket of goods that cost $1,000 in 1980 would cost $1,780 by 1989 due to inflation. If the individual had a $1,000 pension in 1980, that pension would have increased to $1,860 by 1989. Thus, the individual is more than kept whole despite 13 percent inflation in 1980 and no Post Fund increase in that year. By 1999, that

same basket of goods from 1980 would now cost $2,420 dollars, but the pension would be $3,390. The pension is nearly $1,000 per month more than is necessary to keep the retiree whole. The years 2000 through 2002 provided very high Post Fund increases with modest inflation. By 2002, the basket of goods now costs $2,610, but the individual's monthly benefit has grown to $4,310. The individual can purchase the same goods as in 1980 and have $1,700 left over.

For an individual who retired in 1990, a basket of goods that cost $1,000 in 1990 will cost $1,420 in 1999. But if the individual had a $1,000 pension in 1990, the individual is receiving a $1,820 benefit by 1999, not far from doubling within that period. By 2002 that person's benefit has increased to $2,310, while the basket of goods will cost $1,530, leaving $780 per month left over.

*If inflation as measured by the CPI over time is a good measure of inflation for this group, then Post Fund increases since 1980 have been far in excess of amounts necessary to keep retirees whole.* This conclusion would not change if the most recent years (2003, 2004, and 2005) are added to the analysis. Benefit increases were quite modest in those years, but thankfully so was inflation.

Current Situation: What Went Wrong

The Post Fund, which during the 1990s was providing extraordinarily high benefit increases due to the boom in the stock market, is now facing considerable trouble. The very high benefit increases of the 1990s and early 2000s were sustainable providing that the assets continued to earn the investment returns necessary to keep the system healthy, the six percent return to support the existing annuity benefits and up to an additional 2.5 percent return to pay for any newly awarded inflation match. Unfortunately, the domestic stock market, and to a lesser extent the foreign stock market, plummeted. In one calendar year the domestic market had a negative ten percent return, followed by another year with a negative ten percent return, followed by a year with a negative 20 percent return. The returns for the Post Fund as a whole were very low or negative. The fund was not making the minimum six percent return needed to sustain the existing annuities, and was required under law to keep matching inflation up to 2.5 percent. Although inflation in a few years was less than the 2.5 percent cap, there was some degree of inflation, and the inflation match further added to the funding problem. The low or negative returns created unfunded liabilities in the Post Fund. Under the operation of the Post Fund, these asset shortfalls (unfunded obligations) are allocated to the five (five-year) accounts as negative amounts, which must be covered before there is any net positive amount in the yearly accounts to generate some investment-based increases above any required inflation match.

At the current time, the pension fund directors indicate that the Post Fund has gone from being fully funded to having over $4 billion in unfunded liabilities. Under current law, these unfunded liabilities must be covered by asset growth through investment returns before there can be any positive amounts to generate any investment-based increases above the maximum inflation match. The fund administrators have indicated that *even with a prolonged period of above average returns,* it will take at least 12 years before any increases above the 2.5 percent inflation match can be generated.

The operations of the Post Fund, due to the investment markets that have occurred over time, have created groups of winners and losers. Retirees during the 1980s and 1990s received far more in benefit adjustments than was needed to keep them whole. Failure to save enough of those assets generated through investment returns to ensure that reasonable adjustment can be paid in the future has created the current, very difficult situation. One group which is hit hard includes new retirees. While older retirees may do well for some years because of the generous increases granted during the 1990s, new retirees face a decade or more of minimal increases at best. The effect will not be severe if inflation stays low. If high inflation occurs, the newer retirees will suffer considerable erosion of purchasing power.

Past Proposal – 2000 Session S.F. 2674 (Stumpf)

In 2000, the pension fund directors and the State Board of Investment suggested legislation (introduced as S.F. 2674 (Stumpf)) that would have created ten (ten-year) accounts rather than the current five. If investment returns are high, the additional asset value this represents would be spread out over ten years, rather than five. This would save more of this asset value for lean years when returns are low. Similarly, negative allocations would be spread over ten years. In general, the ten-year spreading would reduce any short-term spikes in the post-retirement increases, and generally reduce the variability of Post Fund increases over time.

S.F. 2674 (Stumpf) stemmed, in part, from the extraordinary Post Fund increases that were produced in the late 1990s and early 2000s. The State Board of Investment and the pension fund directors correctly

envisioned that the boom period must end, and it would be followed by a bust, a period of prolonged low post-retirement adjustments. S.F. 2674 (Stumpf) was not enacted. At the time this ten-year averaging proposal was considered, retirees were generally in opposition to the proposed legislation. The Post Fund had treated retirees and other benefit recipients very generously, and those recipients were reluctant to allow any tampering with the mechanism.

Current Proposal – S.F. 70 (Betzold); H.F. 40 (Smith)

S.F. 70 (Betzold); H.F. 40 (Smith) would cap the increase payable from the SBI Post Fund (the sum of the up to 2.5 percent inflation match and any further investment-based adjustment) at five percent in any given year. The effect of this proposal would be similar to the effect of the proposal discussed above – post-retirement adjustments would be more consistent over time. This effect would not be due to use of ten (ten-year) accounts rather than five, as in the prior proposal, but due rather to the five-percent cap. If the assets allocated to the current year are sufficient to provide more than a five percent total increase, the increase must be capped at five percent and any additional assets that are not needed to support the increase must be allocated to the future. This will help to support an increase in a future year when the increase might otherwise be minimal and insufficient.

The pension fund directors have run simulations assuming the proposed system had been in place in the past, and the results indicate that the cap would have been more than fair to the retirees and that there would be no current Post Fund funding problem. In the simulation, the Post Fund would be able to soon provide additional increases above inflation. This would be accomplished by eliminating the high Post Fund increases that occurred in much of the 1990s and into the early 2000s as indicated in the previous chart. Although the increases are capped at five percent, inflation was lower than five percent in every year during that period except 1991 (in 1991, the Post Fund provided a 5.1 percent increase while inflation was 6.1 percent). Thus, even with a five percent cap the retirees would have received increases that exceeded inflation by considerable amounts for the period as a whole. The cap would have freed up considerable reserves (all the reserves that were needed to support the increases above five percent), which could then be used currently, as needed.

While the proposal has the advantages indicated, it also has shortcomings. Like so many of the changes in the past to the Minnesota Adjustable Fixed Benefit Fund and to the Post Fund, the proposed change seems motivated by looking backward rather than by beginning with a clean conceptual slate. The proposal addresses a past problem; for nearly two decades the Post Fund provided adjustments that greatly exceeded inflation, and in the process used up assets in order to support these higher annuities, assets which are desperately needed now to support the increases that will be needed in the future to keep retirees whole. The proposed solution is to cap increases at five percent. This would provide reasonable results looking at the past. It may not work at all well in the future. If rates of inflation in excess of five percent occur, individuals will not be kept whole, even if the system were to have sufficient assets to pay the higher annuities. If enacted, the Legislature may again need to revisit Post Fund policy when a sustained period of high inflation occurs.

S.F. 70 (Betzold); H.F. 40 (Smith) raises the following pension and public policy issues:

1. Extent of Support by Interested Parties. The proposal would impact existing MSRS, PERA, and TRA active, disabled, and retired members. The Commission may wish to determine by testimony or other means the extent of support by these groups for the current proposal.

2. Existing Retirees Benefit Takeaway or Deferral Issue, Possible Litigation. In any year in which the cap restricts the benefit adjustment that is provided, a portion of the benefit adjustment is pushed out into the future. Retirees or other benefit recipients could contend they are harmed by the delay due to the time value of money, and older retirees may contend that they may not survive to receive that delayed increase. This might lead to litigation if these amounts are deemed substantial.

3. Implications of Successful Litigation. The issue or question is what remedial action the Legislature could take if the courts conclude that the proposed change is a benefit takeaway, and amounts to a breach of the contract implied by the adjustment mechanism that existed in statute at the time the individual retired. A solution could be costly or cumbersome, requiring SBI to create two Post Funds, one with the existing-law system for existing retirees and another Post Fund with a cap for new retirees.

4. Question of Consistency with Federal Regulations. The issue is whether the existing or proposed revised Post Retirement Fund benefit adjustment system is consistent with federal requirements.

Questions have been raised regarding whether the existing or proposed Post Fund adjustment mechanism is consistent with final regulations under Internal Revenue Code 401(a)(9). The Post Fund's adjustment system is ultimately based on better-than-assumed investment performance, performance in excess of six percent, with a form of five-year averaging used to create the new, higher benefit levels. Materials provided by MSRS and TRA, including an Internal Revenue Bulletin from June 28, 2004, and other items which attempt to interpret the regulations, indicates that better-than-assumed-investment-based-increase systems are permitted under the regulation if the underlying interest earnings assumption is at least three percent. That is not a problem since the Post Fund adjustments are based on a six percent return assumption. However, some of the discussion suggests that any increase generated by excess investment return must be distributed within a year or two of the occurrence of that return. That suggests that our use of five-year averaging to distribute the excess returns, when they exist, might be a problem. The executive directors of MSRS, PERA, and TRA, however, have evidently concluded that compliance will not be a problem. The Commission may wish to have one of the executive directors provide and overview of this compliance issue and seek assurance from the executive directors that the Post Fund and this cap proposal are on sound footing.

5. Temporary Nature of the Proposed Solution. The Commission may choose to consider that if the Legislature's intention in creating the Post Fund adjustments was to keep retirees whole, then the tool used is seriously flawed. The benefit adjustments generated by Post Fund investment returns are based directly on investment returns and are not capable of tracking the inflation rate except by chance. The past Legislative actions to revise the Minnesota Adjustable Fixed Benefit Fund and later the Post Fund were, in part, efforts to address a tendency for these mechanisms at given points in time to either under-compensate (the Minnesota Adjustable Fixed Benefit Fund in the 1970s) or over-compensate (the Post Fund during the 1980s and 1990s, until the last few years). The current proposal will cap the Post Fund adjustment at five percent per year. This does nothing to address the tracking problem, while the cap will cause considerable harm in a high inflation period. If the proposal is enacted, the Legislature will likely be asked in a future inflationary period to again revise the Post Fund, and possibly asked to provide an ad hoc increase to address harm caused by the cap.

6. Inconsistency with the Commission's Principles of Pension Policy. The issue is the inconsistency of this proposal with the Commission's Principles of Pension Policy, which indicate in relevant part that the Legislature should strive to create pensions which are adequate at the time of retirement, and then take steps to ensure that the benefit remains adequate during retirement by revising the benefit as necessary given inflation. An alternate to the current proposal is to increase the inflation match component above the current maximum 2.5 percent match, but this is likely to generate liabilities.

7. Alternative of a Study. In lieu of the current proposal, the Commission may wish to consider studying the issue over the Interim. There is no immediate urgency to enact the current proposal. Given the current funding condition of the Post Fund, it will be many years before the Post Fund could generate an increase of five percent or above.

8. Proper Cap Level. If the Commission supports the concept of a cap, the Commission may wish to consider the proper level of the cap. Rather than a five percent cap, the cap could be set at some higher or lower level. Assuming the Post Fund had sufficient assets and investment return, a six percent cap would allow more to be paid out in a given year, saving less for a future rainy day. A four percent cap would save more funding for a rainy day, but would increase the gap between the benefit adjustment and the inflation rate in high inflation years.

9. Treatment of Excess. The issue is specifically how to treat any excess assets that are generated by imposing the cap. The drafting does not explicitly state what is to be done with those assets. One option would be to allocate all of the excess assets to the next year's account, which would make it more likely that an adjustment above the limited inflation match could be made in that following year. Another alternative would be to reallocate any excess assets in equal portions to each of the next four (five-year) accounts, which might provide more stability over time.

Potential Amendments for Commission Consideration

The Commission may wish to consider the following amendments. Amendment LCPR05-045 is technical while amendments LCPR05-046, LCPR05-047, and LCPR05-048 are largely substantive.

LCPR05-045 is a technical amendment. The section being amended by S.F. 70 (Betzold); H.F. 40 (Smith) contains several references to the "Commission-retained actuary." Due to legislation enacted in 2004, the Commission no longer retains an actuary. The Commission-retained actuary has been replaced by an

actuary retained jointly by the major pension fund administrations. The amendment deletes references to the "Commission-retained" actuary and replaces them with references to the joint actuary, and also adds an effective date.

LCPR05-046 could be used to change the cap from five percent to a percent to be specified.

LCPR05-047. The bill as drafted does not state what is to be done with any excess reserves due to the cap. Amendment LCPR05-046 specifies that that any excess reserves due to the cap are to be allocated to the next year. This would make it more likely that an adjustment above the limited inflation match could be made in that following year.

LCPR05-048 is an alternative to LCPR05-047. Amendment LCPR05-048 specifies that any excess reserves due to the cap are to be allocated in equal amounts to each of the next four years. This might provide more stability over time than amendment LCPR05-047.

Mary Vanek

**To:** Dave Bergstrom
**Subject:** Summary of Conversation with Rod

Rod believes that Segal (Melanie Walker) agrees that Mellon's opinion is too strict an interpretation.

Rod is of the opinion that as long as the regulations are silent on the issue of averaging, that we should be okay, because the regs don't clearly prohibit averaging.. He believes the regulations are silent because the IRS hasn't a clue about how the public sector uses averaging of this nature. Rod believes that a good faith interpretation would allow the averaging method to continue as long as the plan assets are being paid out and therefore create taxable income.

Melanie on the otherhand has a softer interpretation saying, as he understands it, that because the regulations are silent, she is unsure whether we could continue using our 5-year averaging method.

Rod then asked the question, that if we are comfortable that the averaging is allowed, does the rest of the package fit within the regulations. It is his interpretation that the combination of cola, cap and 13th check is problematic. He thinks that the cola measurement and the cap should be acceptable since they clearly fall within the spirit of the new 401(a)(9) regulations. But, he thinks that adding the 13th check on top of the 5 percent cap could be a problem. Even though the first two pieces don't specifically fit within the pigeon holes of the regulations, those two pieces are within the spirit.

He says the only way to find out is to ask the question of the IRS, but when I mentioned that we were thinking of putting a delayed effective date on this of probably June 30, 2009, he wouldn't suggest an IRS request. We have time to see if the remedial legislation to clarify the regs that should come out of Congress before the effective date would give us time to fix anything. Thus he views our proposal as a low risk proposition with the delayed effective date, but still thinks the 13th check probably isn't a good idea to be included at this time.



LCP & R JAN 09 2006

Human Resources & Investor Solutions

August 26, 2004

Mr. Gary Austin
Executive Director
State of Minnesota
Teachers Retirement Association
60 Empire Drive, Suite 400
St. Paul, MN 55103

*Re: Proposed Changes to the Minnesota Post-Retirement Investment Fund (MPRIF) Cost-of-Living Feature*

Dear Gary:

As requested, we have reviewed the proposed changes to the operation of the MPRIF cost-of-living feature in light of the recently issued final IRS regulations under IRC Section 401(a)(9).

**CURRENT COST-OF-LIVING FEATURE**

Currently, there is a two-part calculation for increases to benefits under the MPRIF. The first part is an inflation-based component equal to the lesser of inflation or 2.50%. The second part is an investment-based component, based on investment performance of the MPRIF funds over a five-year period. The cost-of-living percentage increase is equal to the total of these two components.

**PROPOSED COST OF LIVING FEATURE**

It is our understanding that the proposed change would be to limit the total increase to 5% annually. Thus, the first part of the formula would remain as an inflation-based component equal to the lesser of inflation or 2.50%. The second part would be an investment-based component, based on investment performance of the MPRIF funds over a five-year period, but the total of the inflation and investment based components could never be more than 5% in any year. In addition, there would be a mechanism whereby if the market value of the MPRIF exceeds the actuarial liability by 25% or more, the excess over 25% would be paid immediately in the form of a 13th check.

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## FINAL REGULATIONS UNDER IRC 401(a)(9)

The IRS issued final regulations under IRC 401(a)(9) on June 28, 2004. One of the areas covered under these regulations is the ability to provide investment-based changes where the benefits fluctuate with asset performance or cost-of-living increases to annuity benefits paid from a qualified trust. In particular Q&A 14 of the final regulations addresses these issues. They generally allow benefit increases in a plan year on account of changes in costs of living, as determined under an eligible cost of living index, from the date benefits commence to the date of determination. In addition, they allow for defined benefit plans that pay variable or fixed increases, the following increases:

(1) If annuities are increased by a constant percentage, the increase must be applied at least annually, and the rate ~~must be less than~~ not to exceed 5%.

(2) If the annuities are increased to reflect better than assumed investment return, the assumed rate of return must be at least 3%, but the additional payments resulting from better than assumed investment returns must be paid no later than the year following the year in which the investment gain is measured.

The regulations do not provide for an increase based on the combined increases of the two components (i.e., (1) or (2) above) but do appear to allow for an increase based on the combination of either the fixed percentage increase or the investment based increase and the permitted cost-of-living increase discussed above.

## COMPLIANCE ISSUES WITH CURRENT AND PROPOSED STRUCTURES

The current approach taken by the MPRIF does not comply with the requirements of the final regulations in that it provides for an increase based on the smoothing of better-than-assumed investment returns over five years, which violates the one-year rule mentioned above.

The proposed approach would also not comply with the requirements of the final regulations for the same reason. The 13th check component would not violate the regulations because it will pay those gains within one year of the year in which the investment gains occurred.

In the case of governmental plans, however, the regulations provide a grandfather rule for annuity distribution options in effect on April 17, 2002. Under this rule, a plan will not fail to satisfy Section 401(a)(9) merely because annuity payments under such options do not satisfy these regulations; however, the grandfathered distribution option benefit must satisfy Section 401(a)(9) based on a reasonable, good faith interpretation.

It appears to us that your plan would be able to satisfy this requirement with respect to its grandfathered distribution benefits. However, it appears to us any changes in a grandfathered distribution benefit would cause the loss of the grandfather rule and thus require the changed distribution option or feature to satisfy the requirements of the final 401(a)(9) regulations. Of course, it is certainly worth asking the IRS for relief in the rule to allow you to adopt your proposal, arguing that the change is definitely more in conservative and line with the intent of the

final regulations than the current structure. If granted by the IRS, grandfathered status for your revised distribution feature would be retained.

**EFFECTIVE DATE**

These final regulations are effective June 15, 2004 and apply to required minimum distributions for calendar years beginning on or after January 1, 2003. However, distributions made for calendar years 2003, 2004, and 2005 need not comply entirely with the new regulations, as long as they satisfy Section 401(a)(9) based on a reasonable good faith interpretation. A distribution that satisfies the 1987 proposed regulations, the 2001 proposed regulations, the 2002 temporary and proposed regulations, or these final regulations will be deemed to satisfy a reasonable good faith interpretation of Section 401(a)(9).

For governmental plans like yours, the reasonable good faith standard extends to the later of December 31, 2005, or the end of the calendar year containing the 90th day after the opening of the first legislative session of the legislative body with the authority to amend the plan. We believe your plan will satisfy the good faith compliance rule until the regulations become effective and that your grandfathered distribution feature, as in effect on April 17, 2002, will be protected after the effective date of the regulations for governmental plans. As indicated above, it appears to us that, unless IRS relief is granted, any change in these grandfathered provisions would jeopardize the grandfather protection referred to above.

Please note that Mellon HR&IS is not a law firm, and we cannot provide legal opinions. We recommend that you have this issue addressed by your outside counsel or by the State Attorney General.

Please call me if you have any questions regarding these projections.

Sincerely,

Frederick W. Rumack
Director of Tax and Legal Consulting and Product Development

Michael Moehle, F.S.A., E.A., M.A.A.A.
Principal and Consulting Actuary

FWR/MM:JS/EP
DOC:L07281MR.DOC

Mary Vanek

**From:** Luther Thompson [Luther.Thompson@state.mn.us]
**Sent:** Tuesday, July 06, 2004 9:55 AM
**To:** Mary M. Vanek; Dave Bergstrom
**Subject:** FW: MINN TRA COLA and 401(a)(9)

I am not still not sure what 401 (a) (9) requires for our post retirement fund compliance. If you have any good advice or firm conclusions please let me know. Thanks. Luther

-----Original Message-----
From: Powell, David [mailto:dpowell@groom.com]
Sent: Thursday, July 01, 2004 3:14 PM
To: Luther Thompson
Subject: MINN TRA COLA and 401(a)(9)

Luther - You have asked us to briefly review whether the cost-of-living adjustments (COLA) under the Minnesota Teachers Retirement Association (TRA) satisfy the regulations under Code section 401(a)(9), and if not, what actions TRA should take, if any.

We understand that under the current TRA COLA provisions, the Post Fund of the State Board of Investment provides an annual adjustment to a member's monthly pension benefit. The annual adjustment formula is based on two components: 1) the increases in the cost of living as reflected by the Consumer Price Index (CPI-W), and 2) the investment performance of the high quality bonds and stocks in the Post Fund portfolio. The cost-of-living component is paid up to a maximum of 2.5 percent based on the CPI-W increase determined at the end of each June 30 fiscal year for the preceding 12-month period. It is paid each year regardless of the amount of investment return. If CPI-W is zero or negative for the 12-month period, the inflation component will be deemed as zero.

The potential for a greater annual adjustment is provided by the investment component that is based on investment returns in excess of the amount needed to pay for the cost-of-living component and to cover the Post Fund's six percent earnings assumption that determined a member's original benefit at retirement. The net gains of the investment component are added to the cost-of-living component to become the annual adjustment. Investment gains and losses are spread over five years to smooth out the volatility of returns. We understand that these COLA provisions were in effect on April 17, 2002.

In 2002, the IRS finalized its long-proposed regulations under Code section 401(a)(9), and made the portion applicable to defined benefit plans, including governmental plans, a temporary regulation generally applicable after 2003. In the June 15, 2004 Federal Register, the IRS has made that temporary regulation final. While CPI increases are allowed under the regulations, the TRA COLA provisions do not appear to comply with the temporary or final regulations implementing the statutory requirement that annuities be "substantially nonincreasing" because of the combination with the investment component. While that component resembles the "actuarial gains"-based COLA permitted under the regulations, it is not clear that it strictly complies with the definition, and in any event, it is understood that "hybrid" combinations of more than one of the permitted COLAs in the regulations would likely not comply with the regulations. However, the IRS has issued both transition relief and a grandfather that may benefit TRA.

The transition relief provides that only reasonable, good faith compliance with the 401(a)(9) rules is required before 2006, or for a governmental plan, if later, the end of the calendar year that contains the 90th day after the opening of the first legislative session of the legislative body with the authority to amend the plan that begins on or after June 15, 2004, if such 90th day is later than December 31, 2005. The regulations further grant a "grandfather" to any "annuity distribution option provided under the terms of a governmental plan as in effect on April 17, 2002, so long as the plan satisfies a reasonable and good faith interpretation of Code section 401(a)(9)." The TRA COLA should therefore be grandfathered.

Moreover, there are ongoing legislative efforts to change the statute retroactively to permit governmental defined benefit plans to comply with 401(a)(9) on a reasonable, good faith basis, and these are also intended to permit governmental COLAs in manners such as provided by TRA. (As you know, many governmental plans apply COLAs or other annuity increases which would not comply with the current regulations for various reasons.)

Accordingly, a change to the TRA COLA formula on account of the final MRD regulations should not be required. Note, however, that any future changes to the TRA COLA formula could raise questions as to whether the grandfather may continue to apply, particularly after 2005, unless legislative relief comes first. We would advise continuing to monitor developments in this area, and we are cautiously optimistic that the law will be changed to accommodate the TRA COLA retroactively.

Please let me know if you have any questions about this.

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**Internal Revenue bulletin**

**Bulletin No. 2004-26**
**June 28, 2004**

# HIGHLIGHTS OF THIS ISSUE

**These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.**

## INCOME TAX

### Rev. Rul. 2004–55, page 1081.

**Disability insurance benefits.** This ruling addresses the income tax treatment of short-term and long-term disability benefits under sections 104(a)(3) and 105(a) of the Code.

### Rev. Proc. 2004–37, page 1099.

This procedure provides a method for determining the source of a pension payment to a nonresident alien from a defined benefit plan where the trust forming part of the plan is a trust created or organized in the United States that constitutes a qualified trust under section 401(a) of the Code. Rev. Proc. 2004–7 amplified.

## EMPLOYEE PLANS

### T.D. 9130, page 1082.

Final regulations concern required minimum distributions under section 401(a)(9) of the Code for defined benefit plans and annuity contracts providing benefits under qualified plans, individual retirement plans, and section 403(b) contracts. This document also contains a change to the separate account rules in the final regulations concerning required minimum distributions for defined contribution plans.

## EXEMPT ORGANIZATIONS

### Announcement 2004–53, page 1105.

A list is provided of organizations now classified as private foundations.

**Finding Lists begin on page ii.**
**Index for January through June begins on page vi.**

Department of the Treasury
**Internal Revenue Service**

LCP & R JAN 09 2006

# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

# Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

**Part I.—1986 Code.**
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

**Part II.—Treaties and Tax Legislation.**
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

**Part III.—Administrative, Procedural, and Miscellaneous.**
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

**Part IV.—Items of General Interest.**
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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# Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

## Section 104.—Compensation for Injuries or Sickness

*(Also section 105.)*

**Disability insurance benefits.** This ruling addresses the income tax treatment of short-term and long-term disability benefits under sections 104(a)(3) and 105(a) of the Code.

## Rev. Rul. 2004–55

ISSUE

Under the Amended Plan described below, are long-term disability benefits received by an employee who becomes disabled excludable from the employee's gross income under § 104(a)(3) of the Internal Revenue Code?

FACTS

The Employer provides long-term disability benefits to its eligible employees pursuant to a written plan. Long-term disability benefits are provided through a group insurance policy with a third-party insurance carrier. Under the terms of the plan, the Employer pays the entire premium for the coverage and does not include the cost of the coverage in the employee's gross income (*i.e.*, the premiums are paid on a pre-tax basis and are not reported on the employee's Form W-2 for that year).

The Employer amends the plan (the Amended Plan) to provide that the Employer will continue to pay the long-term disability coverage on a pre-tax basis for eligible employees. However, each eligible employee may also irrevocably elect to have the Employer pay for the long-term disability coverage on an after-tax basis (*i.e.*, elect to be taxed currently on the premiums paid by the Employer). An employee's election applies to the entire cost of the coverage that the Employer pays to the third-party insurance carrier, so that an employee may not elect after-tax treatment for only a portion of the premiums. If an employee elects after-tax treatment, the Employer allocates the appropriate proportion of the group premium to that employee and includes that amount in the employee's gross income for the year in which the payments are made (*i.e.*, the premiums are reported on the employee's Form W-2 for that year).

Under the Amended Plan, the employee's election to pay for the cost of long-term disability coverage on an after-tax basis is irrevocable once the plan year begins and must be made prior to the beginning of the plan year in which the election becomes effective. The employee has the ability to make a new irrevocable election for each plan year prior to the beginning of that plan year. In lieu of a new election for each plan year, the Employer may provide that an employee's prior election, once made, continues from one year to the next unless affirmatively changed before the beginning of the new plan year. The Employer may also provide that the long-term disability premiums will automatically be included in the employee's gross income for the year unless the employee affirmatively elects otherwise prior to the beginning of the new plan year. Under the Amended Plan, an employee who becomes eligible for long-term disability coverage during a plan year (*e.g.*, a newly hired employee) may make an irrevocable prospective election for the remainder of that plan year.

LAW AND ANALYSIS

Section 61(a)(1) and § 1.61–21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in Subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 104(a)(3) states that except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 for any prior taxable year, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee, or are paid by the employer).

Section 1.104–1(d) states that if an individual purchases a policy of accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under § 104(a)(3). Conversely, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for his employees (on either a group or individual basis), the exclusion provided under § 104(a)(3) does not apply to any amounts received by his employees through such fund or insurance. Section 1.104–1(d) refers to § 1.105–1 for rules relating to the determination of the amount attributable to employer contributions.

Section 1.105–1(b) provides that all amounts received by employees through an accident or health plan which is financed solely by their employer are subject to the provisions of § 105(a).

Under § 105(a), amounts received by an employee through accident or health insurance for personal injuries or sickness must be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

Section 1.105–1(c)(1) provides that in the case of amounts received by an employee through an accident or health plan which is financed partially by his employer and partially by contributions of the employee, § 105(a) applies to the extent that such payments are attributable to contributions of the employer that were not includible in the employee's gross income. The portion of the amounts which is attributable to the contributions of the employer shall be determined in accordance with § 1.105–1(d) in the case of insured plans.

Section 1.105–1(c)(2) provides that a separate determination of the portion of the amounts received under the accident or health plan which is attributable to the contributions of the employer shall be made with respect to each class of employees in any case where the plan provides that some classes of covered employees contribute

but others do not, or that the employer will make different contributions for different classes of employees, or that different classes of employees will make different contributions, and where in any such case both the contributions of the employer on account of each such class of employees and the contributions of such class of employees can be ascertained.

Section 1.105–1(d)(2) provides that if the accident or health coverage is provided under or is part of a group insurance policy purchased by contributions of the employer and of the employees, and the net premiums for such coverage for a period of at least three policy years are known at the beginning of the calendar year, the portion of any amount received by an employee which is attributable to the contributions of the employer for such coverage shall be an amount which bears the same ratio to the amount received as the portion of the net premiums contributed by the employer for the last three policy years which are known at the beginning of the calendar year bears to the total of the net premiums contributed by the employer and all employees for such policy years. This provision is known as the "three-year look back rule."

The term "class of employees" as used in § 1.105–1(c)(2) is dependent solely on the contribution method used by the plan. The regulations do not refer to length of service, duties, or other factors as determinative of a "class of employees." Accordingly, under the Amended Plan, the group of employees that elects after-tax treatment of the long-term disability coverage is a separate class of employees under § 1.105–1(c)(2).

In addition, when a plan that provides long-term disability benefits is amended as described above, the Amended Plan is a new plan in computing the contributions of the Employer and the employees. With respect to each employee, the Amended Plan is financed either solely by the Employer or solely by the employee. At no time is the coverage under the Amended Plan financed by both Employer and employee contributions. Therefore, the Amended Plan is not a contributory plan within the meaning of § 1.105–1(c)(1) and, because the Amended Plan is not described in § 1.105–1(c)(1), the "three-year look back rule" set forth in § 1.105–1(d)(2) does not apply.

Finally, the applicable statutes and regulations do not distinguish between short-term and long-term disability plans. Thus, if an employer offers both short-term and long-term disability plans and permits employees to separately elect the contribution payment method for each plan, the law does not require aggregation of the contributions paid for each plan in determining the taxation of benefits. Benefits paid under a short-term or long-term disability plan will be taxed according to the contribution payment election made for each type of coverage.

HOLDING

Under the Amended Plan, long-term disability benefits received by an employee who has irrevocably elected, prior to the beginning of the plan year, to have the coverage paid by the Employer on an after-tax basis for the plan year in which the employee becomes disabled are attributable solely to after-tax employee contributions and are excludable from the employee's gross income under § 104(a)(3).

Under the Amended Plan, long-term disability benefits received by an employee whose coverage is paid by the Employer on a pre-tax basis for the plan year in which the employee becomes disabled are attributable solely to pre-tax Employer contributions and are includible in the employee's gross income under § 105(a).

These holdings are equally applicable to short-term disability benefits.

DRAFTING INFORMATION

The principal author of this revenue ruling is Barbara E. Pie of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Ms. Pie at (202) 622–6080 (not a toll-free call).

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## Section 105.—Amounts Received Under Accident and Health Plans

This ruling addresses the income tax treatment of short-term and long-term disability benefits under sections 104(a)(3) and 105(a) of the Code. See Rev. Rul. 2004-55, page 1081.

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## Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

*26 CFR 1.401(a)(9)–6: Required minimum distributions for defined benefit plans and annuity contracts.*

## T.D. 9130

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

## Required Distributions From Retirement Plans

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Final regulations

SUMMARY: This document contains final regulations concerning required minimum distributions under section 401(a)(9) for defined benefit plans and annuity contracts providing benefits under qualified plans, individual retirement plans, and section 403(b) contracts. This document also contains a change to the separate account rules in the final regulations concerning required minimum distributions for defined contribution plans. These final regulations provide the public with guidance necessary to comply with the law and will affect administrators of, participants in, and beneficiaries of qualified plans; institutions that sponsor and administer individual retirement plans, individuals who use individual retirement plans for retirement income, and beneficiaries of individual retirement plans; and employees for whom amounts are contributed to section 403(b) annuity contracts, custodial accounts, or retirement income accounts and beneficiaries of such contracts and accounts.

DATES: *Effective Date:* These regulations are effective June 15, 2004.

*Applicability Date:* These regulations apply for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2003.

INFORMATION CONTACT: Cathy Vohs at (202) 622–6090.

SUPPLEMENTARY INFORMATION:

**Background**

These final regulations amend 26 CFR part 1 relating to section 401(a)(9). The regulations provide guidance on the minimum distribution requirements under section 401(a)(9) for plans qualified under section 401(a) and for other arrangements that incorporate the section 401(a)(9) rules by reference. The section 401(a)(9) rules are incorporated by reference in section 408(a)(6) and (b)(3) for individual retirement accounts and annuities (IRAs) (including Roth IRAs, except as provided in section 408A(c)(5)), section 403(b)(10) for section 403(b) annuity contracts, and section 457(d) for eligible deferred compensation plans.

Section 401(a)(9) provides rules for distributions during the life of the employee in section 401(a)(9)(A) and rules for distributions after the death of the employee in section 401(a)(9)(B). Section 401(a)(9)(A)(ii) provides that the entire interest of an employee in a qualified plan must be distributed, beginning not later than the employee's required beginning date, in accordance with regulations, over the life of the employee or over the lives of the employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the employee and a designated beneficiary).

Section 401(a)(9)(C) defines required beginning date for employees (other than 5-percent owners and IRA owners) as April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires. For 5-percent owners and IRA owners, the required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70½, even if the employee has not retired.

Section 401(a)(9)(D) provides that (except in the case of a life annuity) the life expectancy of an employee and the employee's spouse that is used to determine the period over which payments must be made may be redetermined, but not more frequently than annually.

Section 401(a)(9)(E) provides that the term *designated beneficiary* means any individual designated as a beneficiary by the employee.

Section 401(a)(9)(F) provides that, under regulations prescribed by the Secretary, any amount paid to a child shall be treated as if it had been paid to the surviving spouse if such amount will be become payable to the surviving spouse upon such child reaching the age of majority (or other designated event permitted under regulations).

Section 401(a)(9)(G) provides that any distribution required to satisfy the incidental death benefit requirement of section 401(a) is a required minimum distribution.

Section 401(a)(9) also provides that, if the employee dies after distributions have begun, the employee's interest must be distributed at least as rapidly as under the method used by the employee.

Section 401(a)(9) further provides that, if the employee dies before required minimum distributions have begun, the employee's interest must be either distributed (in accordance with regulations) over the life or life expectancy of the designated beneficiary with the distributions beginning no later than 1 year after the date of the employee's death, or distributed within 5 years after the death of the employee. However, under section 401(a)(9)(B)(iv), a surviving spouse may wait until the date the employee would have attained age 70½ to begin taking required minimum distributions.

Comprehensive proposed regulations under section 401(a)(9) were first published in the **Federal Register** on July 27, 1987 (EE–113–82, 1987–2 C.B. 881 [52 FR 28070]). Those proposed regulations were amended in 1997 (REG–209463–82, 1988–1 C.B. 376 [62 FR 67780]) to address the limited issue of the rules that apply when a trust is designated as an employee's beneficiary. Comprehensive proposed regulations were reproposed in the **Federal Register** on January 17, 2001 (REG–130477–00/REG–130481–00, 2001–1 C.B. 865 [66 FR 3928]). The 2001 proposed regulations substantially revised and simplified the rules for defined contribution plans but maintained the basic structure for defined benefit plans and requested additional comments on the rules that should apply to those plans. With respect to annuity payments, the 2001 proposed regulations retained the basic structure of the 1987 proposed regulations and the preamble indicated that the IRS and Treasury were continuing to study these rules and specifically requested updated comments on current practices and issues relating to required minimum distributions from annuity contracts. Commentators on the 2001 proposed regulations provided information on the variety of annuity contracts being developed and available as insurance company products for purchase with separate accounts.

Final and temporary regulations relating to required minimum distributions from qualified plans, individual retirement plans, and section 403(b) annuity contracts, custodial accounts, and retirement income accounts were published in the **Federal Register** on April 17, 2002 (T.D. 8987, 2002–1 C.B. 852 [67 FR 18987]). Proposed regulations that cross reference those temporary regulations were published in the Proposed Rules section of the **Federal Register** on April 17, 2002 (REG–108697–02, 2002–1 C.B. 918 [67 FR 18834]). The final and temporary regulations were effective with the 2003 calendar year.

The 2002 regulations finalized the rules for defined contribution plans and the basic rules regarding the determination of the required beginning date, determination of designated beneficiary and other general rules that apply to both defined benefit and defined contribution plans. The 2002 regulations also provided temporary regulations under §1.401(a)(9)–6T relating to minimum distribution requirements for defined benefit plans and annuity contracts purchased with an employee's account balance under a defined contribution plan. In response to the comments to the 2001 proposed regulations, the temporary regulations significantly expanded the situations in which annuity payments under annuity contracts purchased with an employee's benefit may provide for increasing payments, but this guidance was provided in proposed and temporary form rather than final form in order to give taxpayers an opportunity to comment on these changes.

A public hearing was held on the temporary and proposed regulations on October 9, 2002. At the public hearing, and in comments on the temporary regulations, concerns were raised that requiring compliance with certain of the rules in the temporary regulations in 2003 would not be appropriate. Many of the comments relate to restrictions on variable annuity

payments, and certain other increasing annuity payments, set forth in A–1 of §1.401(a)(9)–6T. Commentators also requested additional guidance in applying the rule in A–12 of §1.401(a)(9)–6T that requires the entire interest under an annuity contract to include the actuarial value of other benefits (such as minimum survivor benefits) provided under the contract and that the rule requiring the inclusion of these values be delayed until the guidance is provided. Finally, commentators requested that special consideration be provided to governmental plans.

In response to these comments and in order to provide adequate time to consider the issues raised, the IRS issued Notice 2003–2, 2003–1 C.B. 257, which provided that, pending the issuance of further regulations, plans are permitted to satisfy certain requirements in the 1987 or 2001 proposed regulations with respect to variable annuity payments in lieu of complying with the corresponding requirements in the 2002 temporary regulations, and that the entire interest under an annuity contract (including an annuity described in section 408(b) or section 403(b)) is permitted to be determined as the dollar amount credited to the employee or beneficiary without regard to the actuarial value of any other benefits (such as minimum survivor benefits) that will be provided under the contract. Notice 2003–2 also provided that, pending the issuance of further regulations under section 401(a)(9), governmental plans are only required to satisfy a reasonable and good faith interpretation of section 401(a)(9). Finally, Notice 2003–2 provided that the transitional relief would continue at least through the year in which additional regulations are published, with a later effective date for certain governmental plans.

In response to the comments received, these final regulations make a number of significant modifications to the proposed and temporary regulations and adopt the regulations as modified. They also make a minor modification to the rules in A–2 of §1.401(a)(9)–8 for separate accounts. These final regulations contain rules relating to minimum distribution requirements for defined benefit plans and annuity contracts purchased with an employee's account balance under a defined contribution plan. For purposes of this discussion of the background of the regulations in this preamble, as well as the explanation of provisions below, whenever the term *employee* is used, it is intended to include not only an employee but also an IRA owner.

**Explanation of Provisions**

*Overview*

These final regulations retain the basic rules of the temporary regulations. For example, distributions of an employee's entire interest must be paid in the form of periodic annuity payments for the employee's or beneficiary's life (or the joint lives of the employee and beneficiary) or over a comparable period certain. The payments must be nonincreasing or only increase as provided in the regulations. As provided in the temporary regulations, the permitted increases under these final regulations include: adjustments to reflect increases in the cost of living; any increase in benefits pursuant to a plan amendment; a pop up in payments in the event of the death of the beneficiary or the divorce of the employee and spouse; or return of employee contributions upon an employee's death. In addition, for both annuity contracts purchased from insurance companies and annuities paid from section 401(a) qualified trusts, the regulations allow variable annuities and other regular increases, if certain conditions are satisfied. The regulations also allow changes in distribution form in certain circumstances.

These regulations retain many rules from the temporary regulations without modification. These include, for example, rules regarding: the distribution of benefits that accrue after an employee's first distribution calendar year; the treatment of nonvested benefits; the actuarial increase to an employee's benefit that must be provided if the employee retires after the calendar year in which the employee attains age 70½; and benefits that commence in the form of an annuity prior to an employee's required beginning date.

*Incidental benefit requirement*

The basic purpose of the incidental benefit rule is to ensure that the payments under the annuity are primarily to provide retirement benefits to the employee. These final regulations retain the basic rule in the temporary regulations that, if distributions commence under a distribution option that is in the form of a joint and survivor annuity where the beneficiary is not the employee's spouse, the incidental benefit requirement will not be satisfied unless the payments to the beneficiary as a percentage of the payments to the employee do not exceed the percentage provided in the table in the regulations. The percentage is based on the number of years that the employee's age exceeds the beneficiary's age, and the percentage decreases as the difference between the ages increases. This reflects the fact that the greater the number of years younger a beneficiary is than the employee, the greater the number of years of expected payments that will be made to the beneficiary after the death of the employee. Under the table in the temporary regulations, a plan may not provide a 100 percent survivor benefit to an employee's nonspouse beneficiary under a joint and survivor annuity if the beneficiary is more than 10 years younger than the employee. Some commentators suggested that an adjustment to the table is appropriate if the employee commences distributions before 70½. This is because, in such a case, more payments are expected to be made while the employee is alive.

In response to these comments, the final regulations provide that, if an employee's annuity starting date is at an age younger than age 70, an adjustment is made to the employee/beneficiary age difference. This adjusted employee/beneficiary age difference is determined by decreasing the age difference by the number of years the employee is younger than age 70 at the annuity starting date. The effect of this change is to permit a higher percentage after an employee's death for employees who commence benefits at earlier ages. Thus, for an employee age 55 at the time of the employee's annuity starting date, a joint and 100 percent survivor annuity can be provided if the survivor is not more than 25 years younger than the employee.

*Increasing annuities (including acceleration and cost-of-living increases)*

These final regulations clarify that a plan may provide an annual increase that does not exceed the increase in an eligible cost-of-living index for a 12-month period ending in the year during which the increase occurs or the prior year. An eligible cost-of-living index is a consumer

price index (CPI) issued by the Bureau of Labor Statistics and based on prices of all items (or all items excluding food and energy), including an index for a population of consumers (such as urban consumers or urban wage earners and clerical workers) or geographic area or areas (such as a given metropolitan area or state).

Under these regulations, a plan may provide for annual cost-of-living increases, or may provide for less frequent cost-of-living increases that are cumulative since the most recent increase (or the employee's annuity starting date, if later), as long as there is no actuarial increase to reflect having not provided increases in the interim years.

For a plan that provides annual increases, but provides a ceiling on the annual increase, and thus does not allow a full cost-of-living increase in some years, the plan may allow an unused portion of the cost-of-living increase to be provided in a subsequent year when the ceiling exceeds the increase in the CPI for that year and still treat the increase in that subsequent year as an increase that does not exceed an eligible cost-of-living index.

Finally, a plan can provide for annuity payments with a percentage adjustment based on the increase in compensation for the position held by the employee at the time of retirement. However, in the case of a nongovernmental plan, this form of adjustment is only permitted if it is provided under the terms of the plan as in effect on April 17, 2002.

In addition to these permitted increases in the amount of annuity payments, the final regulations retain the rules in the temporary regulations allowing an annuity purchased from an insurance company with an employee's account balance under a defined contribution plan to provide for variable and increasing payments and clarify that these rules apply to an annuity contract purchased from an insurance company by a qualified trust for a defined benefit plan. For an annuity contract purchased from an insurance company, these final regulations retain the rule that the total expected future payments (disregarding any payment increases) as of the annuity starting date must exceed the premium being annuitized. This rule insures that annuity payments start at a high enough amount to prevent inappropriate deferral.

In response to comments asking for more flexibility in the rules relating to changes in distribution amounts from an annuity contract purchased from an insurance company, the final regulations replace the rule permitting partial and complete withdrawals with a broader rule permitting all types of acceleration. The final regulations allow any method that retains the same rate of increase in future payments but results in the total future expected payments under the annuity (disregarding any future payment increases and including the amount of any payment made as a result of the acceleration) being decreased, thereby allowing acceleration in the form of a shorter period as well as through withdrawals. In addition, the requirement that a total withdrawal option be available has been eliminated.

These final regulations also permit defined benefit plans under a qualified trust to provide variable or fixed-rate increasing annuities paid directly from the trust, but the control in the regulations on the rate of increase for these annuities is different. For these annuities, increases in payments solely to reflect better-than-assumed investment performance are permitted but only if the assumed interest rate for calculating the initial level of payments is at least 3 percent. Alternatively, fixed rate increases may be provided but only if the rate of increase is less than 5 percent. Paralleling the payment of the undistributed premium at death, the regulations allow a payment at death to the extent that the payments after annuitization are less than the present value of the employee's accrued benefit as of the annuity starting date calculated using the applicable interest and morality under section 417(e).

The rule allowing an acceleration of payments under an annuity has not been extended to annuity payments from a qualified trust. However, as noted below, such plans are permitted to allow changes in form of distribution in certain specific circumstances as described below. In addition, if distribution is in the form of a joint and survivor annuity, the final regulations allow the survivor to convert the survivor annuity into a lump sum upon the death of the employee.

*Permitted changes in form of distribution*

Some commentators requested that employees and beneficiaries be permitted to change the form of future distributions in response to changed circumstances, such as upon retirement or death. In response to these comments, the regulations allow an employee or beneficiary to change the form of future distributions in a number of circumstances provided certain conditions are satisfied. First, if distribution is in the form of a period certain only annuity (*i.e.*, an annuity with no life contingency), the individual may change the form of distribution prospectively at any time. The employee or beneficiary also is permitted to change the form of distribution prospectively upon an employee's actual retirement or upon plan termination, regardless of the form of annuity payments before retirement or plan termination. In addition, an employee may change to a qualified joint and survivor annuity in connection with marriage.

In order to make these changes, the future payments must satisfy section 401(a)(9) (as though payments first commenced on the new annuity starting date, treating the actuarial value of the remaining payments as the employee's or beneficiary's entire interest). As a condition to changes in the form of distribution, whether under a period certain only annuity or a life contingent annuity, the stream of payments from the employee's original annuity starting date (both the payments before and after the change in form) must satisfy section 415 using the interest rate assumption and applicable mortality table in effect as of the annuity starting date. In addition, the end point of the new period certain, if any, may not be later the end point available at the original annuity starting date. Furthermore, the plan must treat an individual electing a new form of distribution under these rules as having a new annuity starting date for purposes of sections 415 and 417. Thus, the payments under the new form must satisfy section 415 as of its new annuity starting date based on the applicable interest rate and applicable mortality table for that date, taking into account prior payments. Although not stated, for plans subject to section 411, any form of distribution or change in the form of distribution must



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not result in an impermissible forfeiture of benefits.

A number of commentators requested that the final regulations provide the rule in prior proposed regulations that allowed minimum distributions from a defined benefit plan to be calculated using the rule for defined contribution plans in §1.401(a)(9)–5. The primary argument for allowing this level of flexibility in calculating distribution amounts from year to year is to allow employees to adjust to changed circumstances. The rules in these final regulations allowing a change in distribution form upon retirement or plan termination, and at any time when distribution is in the form of a term certain only, address this need.

*Value of guarantees in determining account value prior to annuitization*

The final regulations retain the basic rule in the temporary regulations that, before annuitization, the defined contribution plan rules apply. For this purpose, an employee's entire interest under an annuity contract is the dollar amount credited to the employee or beneficiary under the contract plus the actuarial value of any additional benefits (such as survivor benefits in excess of the account balance) that will be provided under the contract. A number of commentators requested guidance on how this actuarial value is calculated and indicated that, in certain circumstances it would be appropriate to disregard this additional value.

The IRS and Treasury believe that it is generally appropriate to reflect the value of additional benefits under an annuity contract, just as the fair market value of all assets generally must be reflected in valuing an account balance under a defined contribution plan. However, in response to these comments, the final regulations allow the additional benefits to be disregarded when there is a *pro-rata* reduction in the additional benefits for any withdrawal, provided the actuarial present value of the additional benefits is not more than 20 percent of the account balance. An example is provided that illustrates an acceptable method of determining the value of an additional benefit that is a guaranteed death benefit. In addition, an exception is provided for an additional benefit in the form of a guaranteed return of premiums upon death.

*Certain payments to children*

The final regulations provide rules governing when, pursuant to section 401(a)(9)(F), payment of an employee's accrued benefit to a child may be treated as if such payments were made to a surviving spouse. Under the final regulations, payments under a defined benefit plan or annuity contract that are made to an employee's child until such child reaches the age of majority (or dies, if earlier) may be treated, for purposes of section 401(a)(9), as if such payments were made to the surviving spouse, provided they become payable to the surviving spouse upon cessation of the payments to the child. In addition, for this purpose, a child may be treated as having not reached the age of majority if the child has not completed a specified course of education and is under the age of 26, or so long as the child is disabled.

*Governmental plans*

A number of commentators raised concerns that governmental plans offer annuity distribution options that are not permitted under the temporary regulations. Most of the suggestions made by commentators on behalf of governmental plans were incorporated into the final regulations, such as expanding the list of acceptable COLAs; permitting lump sum distributions to beneficiaries; and providing for pop-up payments to a surviving spouse after the cessation of payments to a child.

Nevertheless, some substantive changes recommended by or on behalf of governmental plans were not made in the final regulations. In light of the difficulties a governmental plan faces in changing its plan terms (*e.g.*, in some states, the state constitution does not allow elimination of existing distribution options) and the public oversight of such plans, these final regulations provide a grandfather rule under which, in the case of an annuity distribution option provided under the terms of a governmental plan as in effect on April 17, 2002, the plan will not fail to satisfy section 401(a)(9) merely because the annuity payments do not satisfy the requirements set forth in these regulations. However, a grandfathered distribution option must satisfy the statutory requirements of section 401(a)(9), based on a reasonable and good faith interpretation of that section.

This grandfather rule only applies to existing plan provisions. Otherwise, the regulations provide that annuity payments under governmental plans within the meaning of section 414(d) must satisfy the rules for nongovernmental plans. Thus, any new distribution option in a governmental plan or change in a distribution option must comply with the rules applicable to nongovernmental plans under these final regulations.

*Separate accounts under defined contribution plans*

Several comments have been received raising administrative concerns with the rule in the final regulations applicable to defined contribution plans that recognizes separate accounts for purposes of section 401(a)(9) only after the separate account is actually established. In particular, concerns have been raised that, for employees who die late in a calendar year, it is nearly impossible to set up separate accounts by the end of the year so that they can be used to determine required minimum distributions for the year after death. In response to these comments the regulations have been modified to provide that if separate accounts, determined as of an employee's date of death, are actually established by the end of the calendar year following the year of an employee's death, the separate accounts can be used to determine required minimum distributions for the year following the year of the employee's death. Under the separate account rules, post-death investment experience must be shared on a *pro-rata* basis until the date on which the separate accounts are actually established.

**Effective Date**

As provided in the temporary and proposed regulations, these final regulations apply for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2003. However, in order to fulfill the commitment in Notice 2003–2 to allow plans to continue to use certain provisions from the pre-existing proposed regulations and

to provide plan sponsors sufficient time to make any adjustments in their plans needed to comply with these regulations, a distribution from a defined benefit plan or annuity contract for calendar years 2003, 2004, and 2005 will not fail to satisfy section 401(a)(9) merely because the payments do not satisfy the rules in these final regulations, provided the payments satisfy section 401(a)(9) based on a reasonable and good faith interpretation of the provisions of section 401(a)(9). For a plan that satisfies the parallel provisions of the 1987 proposed regulations, the 2001 proposed regulations, the 2002 temporary and proposed regulations, or these final regulations, a distribution will be deemed to satisfy a reasonable good faith interpretation of section 401(a)(9).

For governmental plans, this reasonable good faith standard extends to the end of the calendar year that contains the 90th day after the opening of the first legislative session of the legislative body with the authority to amend the plan that begins on or after June 15, 2004, if such 90th day is later than December 31, 2005.

**Special Analyses**

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because §1.401(a)(9)–6 imposes no new collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Drafting Information**

The principal authors of these regulations are Marjorie Hoffman and Cathy A. Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in the development of these regulations.

* * * * *

**Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for "§1.401(a)(9)–6T" and adding an entry in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

§1.401(a)(9)–6 is also issued under 26 U.S.C. 401(a)(9). * * *

Par. 2. Remove "§1.401(a)(9)–6T" and replace it with §1.401(a)(9)–6 each time it is used in the sections listed below:

§1.401(9)–0
§1.401(a)(9)–1 A–2(b)
§1.401(a)(9)–2 A–1(c)
§1.401(a)(9)–2 A–5
§1.401(a)(9)–2 A–6(a)
§1.401(a)(9)–3 A–1(a)
§1.401(a)(9)–3 A–1(b)
§1.401(a)(9)–3 A–6
§1.401(a)(9)–4 A–4(a)
§1.401(a)(9)–5 A–1(e)
§1.401(a)(9)–8 A–2(a)(3)
§1.401(a)(9)–8 A–6(b)(2)
§1.401(a)(9)–8 A–7
§1.401(a)(9)–8 A–8
§1.403(b)–3 A–1(c)(3)
§1.408–8 A–1(a)
§1.408–8 A–1(b)
§54.4974–2 A–3(a)
§54.4974–2 A–4(b)(2)(i)

Par. 3. Section 1.401(a)(9)–6 is added to read as follows:

*§1.401(a)(9)–6 Required minimum distributions for defined benefit plans and annuity contracts.*

Q–1. How must distributions under a defined benefit plan be paid in order to satisfy section 401(a)(9)?

A–1. (a) *General rules.* In order to satisfy section 401(a)(9), except as otherwise provided in this section, distributions of the employee's entire interest under a defined benefit plan must be paid in the form of periodic annuity payments for the employee's life (or the joint lives of the employee and beneficiary) or over a period certain that does not exceed the maximum length of the period certain determined in accordance with A–3 of this section. The interval between payments for the annuity must be uniform over the entire distribution period and must not exceed one year. Once payments have commenced over a period, the period may only be changed in accordance with A–13 of this section. Life (or joint and survivor) annuity payments must satisfy the minimum distribution incidental benefit requirements of A–2 of this section. Except as otherwise provided in this section (such as permitted increases described in A–14 of this section), all payments (whether paid over an employee's life, joint lives, or a period certain) also must be nonincreasing.

(b) *Life annuity with period certain.* The annuity may be a life annuity (or joint and survivor annuity) with a period certain if the life (or lives, if applicable) and period certain each meet the requirements of paragraph (a) of this A–1. For purposes of this section, if distributions are permitted to be made over the lives of the employee and the designated beneficiary, references to a life annuity include a joint and survivor annuity.

(c) *Annuity commencement.* (1) Annuity payments must commence on or before the employee's required beginning date (within the meaning of A–2 of §1.401(a)(9)–2). The first payment, which must be made on or before the employee's required beginning date, must be the payment which is required for one payment interval. The second payment need not be made until the end of the next payment interval even if that payment interval ends in the next calendar year. Similarly, in the case of distributions commencing after death in accordance with section 401(a)(9)(B)(iii) and (iv), the first payment, which must be made on or before the date determined under A–3(a) or (b) (whichever is applicable) of §1.401(a)(9)–3, must be the payment which is required for one payment interval. Payment intervals are the periods for which payments are received, *e.g.*, bimonthly, monthly, semi-annually, or annually. All benefit accruals as of the last day of the first distribution calendar year must be included in the calculation of the amount of annuity payments for payment intervals ending on or after the employee's required beginning date.

(2) This paragraph (c) is illustrated by the following example:

*Example*. A defined benefit plan (Plan X) provides monthly annuity payments of $500 for the life of unmarried participants with a 10-year period certain. An unmarried, retired participant (A) in Plan X attains age 70½ in 2005. In order to meet the requirements of this paragraph, the first monthly payment of $500 must be made on behalf of A on or before April 1, 2006, and the payments must continue to be made in monthly payments of $500 thereafter for the life and 10-year period certain.

(d) *Single sum distributions*. In the case of a single sum distribution of an employee's entire accrued benefit during a distribution calendar year, the amount that is the required minimum distribution for the distribution calendar year (and thus not eligible for rollover under section 402(c)) is determined using either the rule in paragraph (d)(1) or the rule in paragraph (d)(2) of this A–1.

(1) The portion of the single sum distribution that is a required minimum distribution is determined by treating the single sum distribution as a distribution from an individual account plan and treating the amount of the single sum distribution as the employee's account balance as of the end of the relevant valuation calendar year. If the single sum distribution is being made in the calendar year containing the required beginning date and the required minimum distribution for the employee's first distribution calendar year has not been distributed, the portion of the single sum distribution that represents the required minimum distribution for the employee's first and second distribution calendar years is not eligible for rollover.

(2) The portion of the single sum distribution that is a required minimum distribution is permitted to be determined by expressing the employee's benefit as an annuity that would satisfy this section with an annuity starting date as of the first day of the distribution calendar year for which the required minimum distribution is being determined, and treating one year of annuity payments as the required minimum distribution for that year, and not eligible for rollover. If the single sum distribution is being made in the calendar year containing the required beginning date and the required minimum distribution for the employee's first distribution calendar year has not been made, the benefit must be expressed as an annuity with an annuity starting date as of the first day of the first distribution calendar year and the payments for the first two distribution calendar years would be treated as required minimum distributions, and not eligible for rollover.

(e) *Death benefits*. The rule in paragraph (a) of this A–1, prohibiting increasing payments under an annuity applies to payments made upon the death of an employee. However, for purposes of this section, an ancillary death benefit described in this paragraph (e) may be disregarded in applying that rule. Such an ancillary death benefit is excluded in determining an employee's entire interest and the rules prohibiting increasing payments do not apply to such an ancillary death benefit. A death benefit with respect to an employee's benefit is an ancillary death benefit for purposes of this A–1 if —

(1) It is not paid as part of the employee's accrued benefit or under any optional form of the employee's benefit; and

(2) The death benefit, together with any other potential payments with respect to the employee's benefit that may be provided to a survivor, satisfy the incidental benefit requirement of §1.401–1(b)(1)(i).

(f) *Additional guidance*. Additional guidance regarding how distributions under a defined benefit plan must be paid in order to satisfy section 401(a)(9) may be issued by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

Q–2. How must distributions in the form of a life (or joint and survivor) annuity be made in order to satisfy the minimum distribution incidental benefit (MDIB) requirement of section 401(a)(9)(G) and the distribution component of the incidental benefit requirement of §1.401–1(b)(1)(i)?

A–2. (a) *Life annuity for employee*. If the employee's benefit is paid in the form of a life annuity for the life of the employee satisfying section 401(a)(9) without regard to the MDIB requirement, the MDIB requirement of section 401(a)(9)(G) will be satisfied.

(b) *Joint and survivor annuity, spouse beneficiary*. If the employee's sole beneficiary, as of the annuity starting date for annuity payments, is the employee's spouse and the distributions satisfy section 401(a)(9) without regard to the MDIB requirement, the distributions to the employee will be deemed to satisfy the MDIB requirement of section 401(a)(9)(G). For example, if an employee's benefit is being distributed in the form of a joint and survivor annuity for the lives of the employee and the employee's spouse and the spouse is the sole beneficiary of the employee, the amount of the periodic payment payable to the spouse would not violate the MDIB requirement if it was 100 percent of the annuity payment payable to the employee, regardless of the difference in the ages between the employee and the employee's spouse.

(c) *Joint and survivor annuity, nonspouse beneficiary*—(1) *Explanation of rule*. If distributions commence under a distribution option that is in the form of a joint and survivor annuity for the joint lives of the employee and a beneficiary other than the employee's spouse, the minimum distribution incidental benefit requirement will not be satisfied as of the date distributions commence unless under the distribution option, the annuity payments to be made on and after the employee's required beginning date will satisfy the conditions of this paragraph (c). The periodic annuity payment payable to the survivor must not at any time on and after the employee's required beginning date exceed the applicable percentage of the annuity payment payable to the employee using the table in paragraph (c)(2) of this A–2. The applicable percentage is based on the adjusted employee/beneficiary age difference. The adjusted employee/beneficiary age difference is determined by first calculating the excess of the age of the employee over the age of the beneficiary based on their ages on their birthdays in a calendar year. Then, if the employee is younger than age 70, the age difference determined in the previous sentence is reduced by the number of years that the employee is younger than age 70 on the employee's birthday in the calendar year that contains the annuity starting date. In the case of an annuity that provides for increasing payments, the requirement of this paragraph (c) will not be violated merely because benefit payments to the beneficiary increase, provided the increase is determined in the same manner for the employee and the beneficiary.

(2) *Table*.

| Adjusted employee/beneficiary age difference | Applicable percentage |
|---|---|
| 10 years or less | 100% |
| 11 | 96% |
| 12 | 93% |
| 13 | 90% |
| 14 | 87% |
| 15 | 84% |
| 16 | 82% |
| 17 | 79% |
| 18 | 77% |
| 19 | 75% |
| 20 | 73% |
| 21 | 72% |
| 22 | 70% |
| 23 | 68% |
| 24 | 67% |
| 25 | 66% |
| 26 | 64% |
| 27 | 63% |
| 28 | 62% |
| 29 | 61% |
| 30 | 60% |
| 31 | 59% |
| 32 | 59% |
| 33 | 58% |
| 34 | 57% |
| 35 | 56% |
| 36 | 56% |
| 37 | 55% |
| 38 | 55% |
| 39 | 54% |
| 40 | 54% |
| 41 | 53% |
| 42 | 53% |
| 43 | 53% |
| 44 and greater | 52% |

(3) *Example.* This paragraph (c) is illustrated by the following example:

*Example.* Distributions commence on January 1, 2003, to an employee (Z), born March 1, 1937, after retirement at age 65. Z's daughter (Y), born February 5, 1967, is Z's beneficiary. The distributions are in the form of a joint and survivor annuity for the lives of Z and Y with payments of $500 a month to Z and upon Z's death of $500 a month to Y, *i.e.*, the projected monthly payment to Y is 100 percent of the monthly amount payable to Z. Accordingly, under A–10 of this section, compliance with the rules of this section is determined as of the annuity starting date. The adjusted employee/beneficiary age difference is calculated by taking the excess of the employee's age over the beneficiary's age and subtracting the number of years the employee is younger than age 70. In this case, Z is 30 years older than Y and is commencing benefit 5 years before attaining age 70 so the adjusted employee/beneficiary age difference is 25 years. Under the table in paragraph (c)(2) of this A–2, the applicable percentage for a 25-year adjusted employee/beneficiary age difference is 66 percent. As of January 1, 2003 (the annuity starting date), the plan does not satisfy the MDIB requirement because, as of such date, the distribution option provides that, as of Z's required beginning date, the monthly payment to Y upon Z's death will exceed 66 percent of Z's monthly payment.

(d) *Period certain and annuity features.* If a distribution form includes a period certain, the amount of the annuity payments payable to the beneficiary need not be reduced during the period certain, but in the case of a joint and survivor annuity with a period certain, the amount of the annuity payments payable to the beneficiary must satisfy paragraph (c) of this A–2 after the expiration of the period certain.

(e) *Deemed satisfaction of incidental benefit rule.* Except in the case of distributions with respect to an employee's benefit that include an ancillary death benefit described in paragraph A–1(e) of this section, to the extent the incidental benefit requirement of §1.401–1(b)(1)(i) requires a distribution, that requirement is deemed to be satisfied if distributions satisfy the minimum distribution incidental benefit requirement of this A–2. If the employee's benefits include an ancillary death benefit described in paragraph A–1(e) of this section, the benefits (including the ancillary death benefit) must be distributed in accordance with the incidental benefit requirement described in §1.401–1(b)(1)(i) and the benefits (excluding the ancillary death benefit) must also satisfy the minimum distribution incidental benefit requirement of this A–2.

Q–3. How long is a period certain under a defined benefit plan permitted to extend?

A–3. (a) *Distributions commencing during the employee's life.* The period certain for any annuity distributions commencing during the life of the employee with an annuity starting date on or after the employee's required beginning date generally is not permitted to exceed the applicable distribution period for the employee (determined in accordance with the Uniform Lifetime Table in A–2 of §1.401(a)(9)–9) for the calendar year that contains the annuity starting date. See A–10 of this section for the rule for annuity payments with an annuity starting date before the required beginning date. However, if the employee's sole beneficiary is the employee's spouse, the period certain is permitted to be as long as the joint life and last survivor expectancy of the employee and the employee's spouse, if longer than the applicable distribution period for the employee, provided the period certain is not provided in conjunction with a life annuity under A–1(b) of this section.

(b) *Distributions commencing after the employee's death.* (1) If annuity distributions commence after the death of the employee under the life expectancy rule (under section 401(a)(9)(B)(iii) or (iv)), the period certain for any distributions commencing after death cannot exceed the applicable distribution period determined under A–5(b) of §1.401(a)(9)–5 for the distribution calendar year that contains the annuity starting date.

(2) If the annuity starting date is in a calendar year before the first distribution calendar year, the period certain may not exceed the life expectancy of the designated beneficiary using the beneficiary's age in the year that contains the annuity starting date.

Q–4. Will a plan fail to satisfy section 401(a)(9) merely because distributions are made from an annuity contract which is purchased from an insurance company?

A–4. A plan will not fail to satisfy section 401(a)(9) merely because distributions are made from an annuity contract which is purchased with the employee's benefit by the plan from an insurance company, as long as the payments satisfy the requirements of this section. If the annuity contract is purchased after the required beginning date, the first payment interval must begin on or before the purchase date and the payment required for one payment interval must be made no later than the end of such payment interval. If the payments actually made under the annuity contract do not meet the requirements of section 401(a)(9), the plan fails to satisfy section 401(a)(9). See also A–14 of this section permitting certain increases under annuity contracts.

Q–5. In the case of annuity distributions under a defined benefit plan, how must additional benefits that accrue after the employee's first distribution calendar year be distributed in order to satisfy section 401(a)(9)?

A–5. (a) In the case of annuity distributions under a defined benefit plan, if any additional benefits accrue in a calendar year after the employee's first distribution calendar year, distribution of the amount that accrues in the calendar year must commence in accordance with A–1 of this section beginning with the first payment interval ending in the calendar year immediately following the calendar year in which such amount accrues.

(b) A plan will not fail to satisfy section 401(a)(9) merely because there is an administrative delay in the commencement of the distribution of the additional benefits accrued in a calendar year, provided that the actual payment of such amount commences as soon as practicable. However, payment must commence no later than the end of the first calendar year following the calendar year in which the additional benefit accrues, and the total amount paid during such first calendar year must be no less than the total amount that was required to be paid during that year under A–5(a) of this section.

Q–6. If a portion of an employee's benefit is not vested as of December 31 of a distribution calendar year, how is the determination of the required minimum distribution affected?

A–6. In the case of annuity distributions from a defined benefit plan, if any portion of the employee's benefit is not vested as of December 31 of a distribution calendar year, the portion that is not vested as of such date will be treated as not having accrued for purposes of determining the required minimum distribution for that distribution calendar year. When an additional portion of the employee's benefit becomes vested, such portion will be treated as an additional accrual. See A–5 of this section for the rules for distributing benefits which accrue under a defined benefit plan after the employee's first distribution calendar year.

Q–7. If an employee (other than a 5-percent owner) retires after the calendar year in which the employee attains age 70$^{1}/_{2}$, for what period must the employee's accrued benefit under a defined benefit plan be actuarially increased?

A–7. (a) *Actuarial increase starting date.* If an employee (other than a 5-percent owner) retires after the calendar year in which the employee attains age 70$^{1}/_{2}$, in order to satisfy section 401(a)(9)(C)(iii), the employee's accrued benefit under a defined benefit plan must be actuarially increased to take into account any period after age 70$^{1}/_{2}$ in which the employee was not receiving any benefits under the plan. The actuarial increase required to satisfy section 401(a)(9)(C)(iii) must be provided for the period starting on the April 1 following the calendar year in which the employee attains age 70$^{1}/_{2}$, or January 1, 1997, if later.

(b) *Actuarial increase ending date.* The period for which the actuarial increase must be provided ends on the date on which benefits commence after retirement in an amount sufficient to satisfy section 401(a)(9).

(c) *Nonapplication to plan providing same required beginning date for all employees.* If, as permitted under A–2(e) of §1.401(a)(9)–2, a plan provides that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attains age 70$^{1}/_{2}$ (regardless of whether the employee is a 5-percent owner) and the plan makes distributions in an amount sufficient to satisfy section 401(a)(9) using that required beginning date, no actuarial increase is required under section 401(a)(9)(C)(iii).

(d) *Nonapplication to governmental and church plans.* The actuarial increase required under this A–7 does not apply to a governmental plan (within the meaning of section 414(d)) or a church plan. For purposes of this paragraph, the term *church plan* means a plan maintained by a church for church employees, and the term *church* means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

Q–8. What amount of actuarial increase is required under section 401(a)(9)(C)(iii)?

A–8. In order to satisfy section 401(a)(9)(C)(iii), the retirement benefits payable with respect to an employee as of the end of the period for actuarial increases (described in A–7 of this section) must be no less than: the actuarial equivalent of the employee's retirement benefits that would have been payable as of the date the actuarial increase must commence under paragraph (a) of A–7 of this section if benefits had commenced on that date; plus the actuarial equivalent of any additional benefits accrued after that date; reduced by the actuarial equivalent of any distributions made with respect to the employee's retirement benefits after that date. Actuarial equivalence is determined using the plan's assumptions for determining actuarial equivalence for purposes of satisfying section 411.

Q–9. How does the actuarial increase required under section 401(a)(9)(C)(iii) relate to the actuarial increase required under section 411?

A–9. In order for any of an employee's accrued benefit to be nonforfeitable as required under section 411, a defined benefit plan must make an actuarial adjustment to an accrued benefit, the payment of which is deferred past normal retirement age. The only exception to this rule is that generally no actuarial adjustment is required to reflect the period during which a benefit is suspended as permitted under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 829). The actuarial increase required under section 401(a)(9)(C)(iii) for the period described in A–7 of this section is generally the same as, and not in addition to, the actuarial increase required for the same period under section 411 to reflect any delay in the payment of retirement benefits after normal retirement age. However, unlike the actuarial increase required under section 411, the actuarial increase required under section 401(a)(9)(C)(iii) must be provided even during any period during which an employee's benefit has been suspended in accordance with ERISA section 203(a)(3)(B).

Q–10. What rule applies if distributions commence to an employee on a date before the employee's required beginning date over a period permitted under section 401(a)(9)(A)(ii) and the distribution form is an annuity under which distributions are made in accordance with the provisions of A–1 of this section?

A–10. (a) *General rule.* If distributions commence to an employee on a date before the employee's required beginning date over a period permitted under section 401(a)(9)(A)(ii) and the distribution form is an annuity under which distributions are made in accordance with the provisions of A–1 of this section, the annuity starting date will be treated as the required beginning date for purposes of applying the rules of this section and §1.401(a)(9)–2. Thus, for example, the designated beneficiary distributions will be determined as of the annuity starting date. Similarly, if the employee dies after the annuity starting date but before the required beginning date determined under A–2 of §1.401(a)(9)–2, after the employee's death, the remaining portion of the employee's interest must continue to be distributed in accordance with this section over the remaining period over which distributions commenced. The rules in §1.401(a)(9)–3 and section 401(a)(9)(B)(ii) or (iii) and (iv) do not apply.

(b) *Period certain.* If, as of the employee's birthday in the year that contains the annuity starting date, the age of the employee is under 70, the following rule applies in applying the rule in paragraph (a) of A–3 of this section. The applicable distribution period for the employee is the distribution period for age 70, determined in accordance with the Uniform Lifetime Table in A–2 of §1.401(a)(9)–9, plus the excess of 70 over the age of the employee as of the employee's birthday in the year that contains the annuity starting date.

(c) *Adjustment to employee/beneficiary age difference.* See A–2(c)(1) of this section for the determination of the adjusted employee/beneficiary age difference in the case of an employee whose age on the annuity starting date is less than 70.

Q–11. What rule applies if distributions commence to the surviving spouse of an employee over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A–1 of this section.

A–11. If distributions commence to the surviving spouse of an employee over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A–1 of this section, distributions will be considered to have begun on the actual commencement date for purposes of section 401(a)(9)(B)(iv)(II). Consequently, in such case, A–5 of §1.401(a)(9)–3 and section 401(a)(9)(B)(ii) and (iii) will not apply upon the death of the surviving spouse as though the surviving spouse were the employee. Instead, the annuity distributions must continue to be made, in accordance with the provisions of A–1 of this section, over the remaining period over which distributions commenced.

Q–12. In the case of an annuity contract under an individual account plan that has not yet been annuitized, how is section 401(a)(9) satisfied with respect to the employee's or beneficiary's entire interest under the annuity contract for the period prior to the date annuity payments so commence?

A–12. (a) *General rule.* Prior to the date that an annuity contract under an individual account plan is annuitized, the interest of an employee or beneficiary under that contract is treated as an individual account for purposes of section 401(a)(9). Thus, the required minimum distribution for any year with respect to that interest is determined under §1.401(a)(9)–5 rather than this section. See A–1 of §1.401(a)(9)–5 for rules relating to the satisfaction of section 401(a)(9) in the year that annuity payments commence and A–2(a)(3) of §1.401(a)(9)–8.

(b) *Entire interest.* For purposes of applying the rules in §1.401(a)(9)–5, the entire interest under the annuity contract as of December 31 of the relevant valuation calendar year is treated as the account balance for the valuation calendar year described in A–3 of §1.401(a)(9)–5. The entire interest under an annuity contract is the dollar amount credited to the employee or beneficiary under the contract plus the actuarial present value of any additional benefits (such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary) that will be provided under

the contract. However, paragraph (c) of this A–12 describes certain additional benefits that may be disregarded in determining the employee's entire interest under the annuity contract. The actuarial present value of any additional benefits described under this A–12 is to be determined using reasonable actuarial assumptions, including reasonable assumptions as to future distributions, and without regard to an individual's health.

(c) *Exclusions.* (1) The actuarial present value of any additional benefits provided under an annuity contract described in paragraph (b) of this A–12 may be disregarded if the sum of the dollar amount credited to the employee or beneficiary under the contract and the actuarial present value of the additional benefits is no more than 120 percent of the dollar amount credited to the employee or beneficiary under the contract and the contract provides only for the following additional benefits:

(i) Additional benefits that, in the case of a distribution, are reduced by an amount sufficient to ensure that the ratio of such sum to the dollar amount credited does not increase as a result of the distribution, and

(ii) An additional benefit that is the right to receive a final payment upon death that does not exceed the excess of the premiums paid less the amount of prior distributions.

(2) If the only additional benefit provided under the contract is the additional benefit described in paragraph (c)(1)(ii) of this A–14, the additional benefit may be disregarded regardless of its value in relation to the dollar amount credited to the employee or beneficiary under the contract.

(3) The Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) may provide additional guidance on additional benefits that may be disregarded.

(d) *Examples.* The following examples, which use a 5 percent interest rate and the Mortality Table provided in Rev. Rul. 2001–62, 2001–2 C.B. 632, illustrate the application of the rules in this A–12:

*Example 1.* (i) G is the owner of a variable annuity contract (Contract S) under an individual account plan which has not been annuitized. Contract S provides a death benefit until the end of the calendar year in which the owner attains the age of 84 equal to the greater of the current Contract S notional account value (dollar amount credited to G under the contract) and the largest notional account value at any previous policy anniversary reduced proportionally for subsequent partial distributions (High Water Mark). Contract S provides a death benefit in calendar years after the calendar year in which the owner attains age 84 equal to the current notional account value. Contract S provides that assets within the contract may be invested in a Fixed Account at a guaranteed rate of 2 percent. Contract S provides no other additional benefits.

(ii) At the end of 2008, when G has an attained age of 78 and 9 months the notional account value of Contract S (after the distribution for 2008 of 4.93% of the notional account value as of December 31, 2007) is $550,000, and the High Water Mark, before adjustment for any withdrawals from Contract S in 2008 is $1,000,000. Thus, Contract S will provide additional benefits (*i.e.*, the death benefits in excess of the notional account value) through 2014, the year S turns 84. The actuarial present value of these additional benefits at the end of 2008 is determined to be $84,300 (15 percent of the notional account value). In making this determination, the following assumptions are made: on the average, deaths occur mid-year; the investment return on his notional account value is 2 percent per annum; and minimum required distributions (determined without regard to additional benefits under the Contract S) are made at the end of each year. The following table summarizes the actuarial methodology used in determining the actuarial present value of the additional benefit.

| Year | Death Benefit During Year | End-of-Year Notional Account Before Withdrawal | Average Notional Account | Withdrawal at End of Year | End-of-Year Notional Account After Withdrawal |
|---|---|---|---|---|---|
| 2008 | $1,000,000 | | | | $550,000 |
| 2009 | $ 950,739[1] | $561,000[2] | $555,500[3] | $28,205[4] | $532,795 |
| 2010 | $ 901,983 | $543,451 | $538,123 | $28,492 | $514,959 |
| 2011 | $ 853,749 | $525,258 | $520,109 | $28,769 | $496,490 |
| 2012 | $ 806,053 | $506,419 | $501,454 | $29,034 | $477,385 |
| 2013 | $ 758,916 | $486,933 | $482,159 | $29,287 | $457,645 |
| 2014 | $ 712,356 | $466,798 | $462,222 | $29,525 | $437,273 |

| Year | Survivorship to Start of Year | Interest Discount to End of 2008 | Mortality Rate During Year | Discounted Additonal Benefits Within Year |
|---|---|---|---|---|
| 2008 | | | | |
| 2009 | 1.00000 | .97590 | .04426[5] | $17,070 |
| 2010 | .95574 | .92943[6] | .04946 | $15,987[7] |
| 2011 | .90847[8] | .88517 | .05519 | $14,807 |
| 2012 | .85833 | .84302 | .06146 | $13,546 |
| 2013 | .80558 | .80288 | .06788 | $12,150 |
| 2014 | .75090 | .76464 | .07477 | $10,739 |
| | | | | $84,300 |

1 $1,000,000 death benefit reduced 4.93 percent for withdrawal during 2008.
2 Notional account value at end of prior year (after distribution) increased by 2 percent return for year.

3 Average of $550,000 notional account value at end of prior year (after distribution) and $561,000 notional account value at end of current year (before distribution).

4 December 31, 2008, notional account (before distribution) divided by uniform lifetime table age 79 factor of 19.5.

5 One-quarter age 78 rate plus three-quarters age 79 rate.

6 Five percent discounted 18 months (1.05^(-1.5)).

7 Blended age 79/age 80 mortality rate (.04946) multiplied by the $363,860 excess of death benefit over the average notional account value (901,983 less 538,123) multiplied by .95574 probability of survivorship to the start of 2010 multiplied by 18 month interest discount of .92943.

8 Survivorship to start of preceding year (.95574) multiplied by probability of survivorship during prior year (1 - .04946).

(iii) Because Contract S provides that, in the case of a distribution, the value of the additional death benefit (which is the only additional benefit available under the contract) is reduced by an amount that is at least proportional to the reduction in the notional account value and, at age 78 and 9 months, the sum of the notional account value (dollar amount credited to the employee under the contract) and the actuarial present value of the additional death benefit is no more than 120 percent of the notional account value, the exclusion under paragraph (c)(2) of this A–12 is applicable for 2009. Therefore, for purposes of applying the rules in §1.401(a)(9)–5, the entire interest under Contract S may be determined as the notional account value (*i.e.*, without regard to the additional death benefit).

*Example 2.* (i) The facts are the same as in *Example 1* except that the notional account value is $450,000 at the end of 2008. In this instance, the actuarial present value of the death benefit in excess of the notional account value in 2008 is determined to be $108,669 (24 percent of the notional account value). The following table summarizes the actuarial methodology used in determining the actuarial present value of the additional benefit.

| Year | Death Benefit During Year | End-of-Year Notional Account Before Withdrawal | Average Notional Account | Withdrawal at End of Year | End-of-Year Notional Account After Withdrawal |
|---|---|---|---|---|---|
| 2008 | $1,000,000 | | | | $450,000 |
| 2009 | $ 950,739 | $459,000 | $454,500 | $23,077 | $435,923 |
| 2010 | $ 901,983 | $444,642 | $440,282 | $23,311 | $421,330 |
| 2011 | $ 853,749 | $429,757 | $425,543 | $23,538 | $406,219 |
| 2012 | $ 806,053 | $414,343 | $410,281 | $23,755 | $390,588 |
| 2013 | $ 758,916 | $398,399 | $394,494 | $23,962 | $374,437 |
| 2014 | $ 712,356 | $381,926 | $378,181 | $24,157 | $357,768 |

| Year | Survivorship to Start of Year | Interest Discount to End of 2008 | Mortality Rate During Year | Discounted Additional Benefits Within Year |
|---|---|---|---|---|
| 2008 | | | | |
| 2009 | 1.00000 | .97590 | .04426 | $21,432 |
| 2010 | .95574 | .92943 | .04946 | $20,286 |
| 2011 | .90847 | .88517 | .05519 | $19,004 |
| 2012 | .85833 | .84302 | .06146 | $17,601 |
| 2013 | .80558 | .80288 | .06788 | $15,999 |
| 2014 | .75090 | .76464 | .07477 | $14,347 |
| | | | | $108,669 |

(ii) Because the sum of the notional account balance and the actuarial present value of the additional death benefit is more than 120 percent of the notional account value, the exclusion under paragraph (b)(1) of this A–12 does not apply for 2009. Therefore, for purposes of applying the rules in §1.401(a)(9)–5, the entire interest under Contract S must include the actuarial present value of the additional death benefit.

Q–13. When can an annuity payment period be changed?

A–13. (a) *In general.* An annuity payment period may be changed in accordance with the provisions set forth in paragraph (b) of this A–13 or in association with an annuity payment increase described in A–14 of this section.

(b) *Reannuitization.* If, in a stream of annuity payments that otherwise satisfies section 401(a)(9), the annuity payment period is changed and the annuity payments are modified in association with that change, this modification will not cause the distributions to fail to satisfy section 401(a)(9) provided the conditions set forth in paragraph (c) of this A–13 are satisfied, and either —

(1) The modification occurs at the time that the employee retires or in connection with a plan termination;

(2) The annuity payments prior to modification are annuity payments paid over a period certain without life contingencies; or

(3) The annuity payments after modification are paid under a qualified joint and survivor annuity over the joint lives of the employee and a designated beneficiary, the employee's spouse is the sole designated beneficiary, and the modification occurs in connection with the employee becoming married to such spouse.

(c) *Conditions.* In order to modify a stream of annuity payments in accordance with paragraph (b) of this A–13, the following conditions must be satisfied —

(1) The future payments under the modified stream satisfy section 401(a)(9) and this section (determined by treating the date of the change as a new annuity starting date and the actuarial present value of the remaining payments prior to modification as the entire interest of the participant);

(2) For purposes of sections 415 and 417, the modification is treated as a new annuity starting date;

(3) After taking into account the modification, the annuity stream satisfies section 415 (determined at the original annuity starting date, using the interest rates and mortality tables applicable to such date); and

(4) The end point of the period certain, if any, for any modified payment period is not later than the end point available under section 401(a)(9) to the employee at the original annuity starting date.

(d) *Examples*. For the following examples in this A–13, assume that the Applicable Interest Rate throughout the period from 2005 through 2008 is 5 percent and throughout 2009 is 4 percent, the Applicable Mortality Table throughout the period from 2005 to 2009 is the table provided in Rev. Rul. 2001–62, 2001–2 C.B. 632, and the section 415 limit in 2005 at age 70 for a straight life annuity is $255,344:

*Example 1*. (i) A participant (D), who has 10 years of participation in a frozen defined benefit plan (Plan W), attains age 70½ in 2005. D is not retired and elects to receive distributions from Plan W in the form of a straight life (*i.e.*, level payment) annuity with annual payments of $240,000 per year beginning in 2005 at a date when D has an attained age of 70. Plan W offers non-retired employees in pay status the opportunity to modify their annuity payments due to an associated change in the payment period at retirement. Plan W treats the date of the change in payment period as a new annuity starting date for the purposes of sections 415 and 417. Thus, for example, the plan provides a new qualified and joint survivor annuity election and obtains spousal consent.

(ii) Plan W determines modifications of annuity payment amounts at retirement such that the present value of future new annuity payment amounts (taking into account the new associated payment period) is actuarially equivalent to the present value of future pre-modification annuity payments (taking into account the pre-modification annuity payment period). Actuarial equivalency for this purpose is determined using the Applicable Interest Rate and the Applicable Mortality Table as of the date of modification.

(iii) D retires in 2009 at the age of 74 and, after receiving four annual payments of $240,000, elects to receive his remaining distributions from Plan W in the form of an immediate final lump sum payment (calculated at 4 percent interest) of $2,399,809.

(iv) Because payment of retirement benefits in the form of an immediate final lump sum payment satisfies (in terms of form) section 401(a)(9), the condition under paragraph (c)(1) of this A–13 is met.

(v) Because Plan W treats a modification of an annuity payment stream at retirement as a new annuity starting date for purposes of sections 415 and 417, the condition under paragraph (c)(2) of this A–13 is met.

(vi) After taking into account the modification, the annuity stream determined as of the original annuity starting date consists of annual payments beginning at age 70 of $240,000, $240,000, $240,000, $240,000, and $2,399,809. This benefit stream is actuarially equivalent to a straight life annuity at age 70 of $250,182, an amount less than the section 415 limit determined at the original annuity starting date, using the interest and mortality rates applicable to such date. Thus, the condition under paragraph (c)(3) of this A–13 is met.

(vii) Thus, because a stream of annuity payments in the form of a straight life annuity satisfies section 401(a)(9), and because each of the conditions under paragraph (c) of this A–13 are satisfied, the modification of annuity payments to D described in this example meets the requirements of this A–13.

*Example 2*. The facts are the same as in *Example 1* except that the straight life annuity payments are paid at a rate of $250,000 per year and after D retires the lump sum payment at age 75 is $2,499,801. Thus, after taking into account the modification, the annuity stream determined as of the original annuity starting date consists of annual payments beginning at age 70 of $250,000, $250,000, $250,000, $250,000, and $2,499,801. This benefit stream is actuarially equivalent to a straight life annuity at age 70 of $260,606, an amount greater than the section 415 limit determined at the original annuity starting date, using the interest and mortality rates applicable to such date. Thus, the lump sum payment to D fails to satisfy the condition under paragraph (c)(3) of this A–13. Therefore, the lump sum payment to D fails to meet the requirements of this A–13 and thus fails to satisfy the requirements of section 401(a)(9).

*Example 3*. (i) A participant (E), who has 10 years of participation in a frozen defined benefit plan (Plan X), attains age 70½ and retires in 2005 at a date when his attained age is 70. E elects to receive annual distributions from Plan X in the form of a 27 year period certain annuity (*i.e.*, a 27 year annuity payment period without a life contingency) paid at a rate of $37,000 per year beginning in 2005 with future payments increasing at a rate of 4 percent per year (*i.e.*, the 2006 payment will be $38,480, the 2007 payment will be $40,019 and so on). Plan X offers participants in pay status whose annuity payments are in the form of a term-certain annuity the opportunity to modify their payment period at any time and treats such modifications as a new annuity starting date for the purposes of sections 415 and 417. Thus, for example, the plan provides a new qualified and joint survivor annuity election and obtains spousal consent.

(ii) Plan X determines modifications of annuity payment amounts such that the present value of future new annuity payment amounts (taking into account the new associated payment period) is actuarially equivalent to the present value of future pre-modification annuity payments (taking into account the pre-modification annuity payment period). Actuarial equivalency for this purpose is determined using 5 percent and the Applicable Mortality Table as of the date of modification.

(iii) In 2008, E, after receiving annual payments of $37,000, $38,480, and $40,019, elects to receive his remaining distributions from Plan W in the form of a straight life annuity paid with annual payments of $92,133 per year.

(iv) Because payment of retirement benefits in the form of a straight life annuity satisfies (in terms of form) section 401(a)(9), the condition under paragraph (c)(1) of this A–13 is met.

(v) Because Plan X treats a modification of an annuity payment stream at retirement as a new annuity starting date for purposes of sections 415 and 417, the condition under paragraph (c)(2) of this A–13 is met.

(vi) After taking into account the modification, the annuity stream determined as of the original annuity starting date consists of annual payments beginning at age 70 of $37,000, $38,480, $40,019, and a straight life annuity beginning at age 73 of $92,133. This benefit stream is equivalent to a straight life annuity at age 70 of $82,539, an amount less than the section 415 limit determined at the original annuity starting date, using the interest and mortality rates applicable to such date. Thus, the condition under paragraph (c)(3) of this A–13 is met.

(vii) Thus, because a stream of annuity payments in the form of a straight life annuity satisfies section 401(a)(9), and because each of the conditions under paragraph (c) of this A–13 are satisfied, the modification of annuity payments to E described in this example meets the requirements of this A–13.

Q–14. Are annuity payments permitted to increase?

A–14. (a) *General rules*. Except as otherwise provided in this section, all annuity payments (whether paid over an employee's life, joint lives, or a period certain) must be nonincreasing or increase only in accordance with one of more of the following —

(1) With an annual percentage increase that does not exceed the percentage increase in an eligible cost-of-living index as defined in paragraph (b) of this A–14 for a 12-month period ending in the year during which the increase occurs or the prior year;

(2) With a percentage increase that occurs at specified times (*e.g.*, at specified ages) and does not exceed the cumulative total of annual percentage increases in an eligible cost-of-living index as defined in paragraph (b) of this A–14 since the annuity starting date, or if later, the date of the most recent percentage increase. However, in cases providing such a cumulative increase, an actuarial increase may not be provided to reflect the fact that increases were not provided in the interim years;

(3) To the extent of the reduction in the amount of the employee's payments to provide for a survivor benefit, but only if there is no longer a survivor benefit be-

cause the beneficiary whose life was being used to determine the period described in section 401(a)(9)(A)(ii) over which payments were being made dies or is no longer the employee's beneficiary pursuant to a qualified domestic relations order within the meaning of section 414(p);

(4) To pay increased benefits that result from a plan amendment;

(5) To allow a beneficiary to convert the survivor portion of a joint and survivor annuity into a single sum distribution upon the employee's death; or

(6) To the extent increases are permitted in accordance with paragraph (c) or (d) of this A–14.

(b)(1) For purposes of this A–14, an eligible cost-of-living index means an index described in paragraphs (b)(2), (b)(3), or (b)(4) of this A–14.

(2) A consumer price index that is based on prices of all items (or all items excluding food and energy) and issued by the Bureau of Labor Statistics, including an index for a specific population (such as urban consumers or urban wage earners and clerical workers) and an index for a geographic area or areas (such as a given metropolitan area or state).

(3) A percentage adjustment based on a cost-of-living index described in paragraph (b)(2) of this A–14, or a fixed percentage if less. In any year when the cost-of-living index is lower than the fixed percentage, the fixed percentage may be treated as an increase in an eligible cost-of-living index, provided it does not exceed the sum of:

(i) The cost-of-living index for that year, and

(ii) The accumulated excess of the annual cost-of-living index from each prior year over the fixed annual percentage used in that year (reduced by any amount previously utilized under this paragraph (b)(3)(ii)).

(4) A percentage adjustment based on the increase in compensation for the position held by the employee at the time of retirement, and provided under either the terms of a governmental plan within the meaning of section 414(d) or under the terms of a nongovernmental plan as in effect on April 17, 2002.

(c) *Additional permitted increases for annuity payments under annuity contracts purchased from insurance companies.* In the case of annuity payments paid from an annuity contract purchased from an insurance company, if the total future expected payments (determined in accordance with paragraph (e)(3) of this A–14) exceed the total value being annuitized (within the meaning of paragraph (e)(1) of this A–14) , the payments under the annuity will not fail to satisfy the nonincreasing payment requirement in A–1(a) of this section merely because the payments are increased in accordance with one or more of the following—

(1) By a constant percentage, applied not less frequently than annually;

(2) To provide a final payment upon the death of the employee that does not exceed the excess of the total value being annuitized (within the meaning of paragraph (e)(1) of this A–14) over the total of payments before the death of the employee;

(3) As a result of dividend payments or other payments that result from actuarial gains (within the meaning of paragraph (e)(2) of this A–14), but only if actuarial gain is measured no less frequently than annually and the resulting dividend payments or other payments are either paid no later than the year following the year for which the actuarial experience is measured or paid in the same form as the payment of the annuity over the remaining period of the annuity (beginning no later than the year following the year for which the actuarial experience is measured); and

(4) An acceleration of payments under the annuity (within the meaning of paragraph (e)(4) of this A–14).

(d) *Additional permitted increases for annuity payments from a qualified trust.* In the case of annuity payments paid under a defined benefit plan qualified under section 401(a) (other than annuity payments under an annuity contract purchased from an insurance company that satisfy paragraph (c) of this section), the payments under the annuity will not fail to satisfy the nonincreasing payment requirement in A–1(a) of this section merely because the payments are increased in accordance with one of the following —

(1) By a constant percentage, applied not less frequently than annually, at a rate that is less than 5 percent per year;

(2) To provide a final payment upon the death of the employee that does not exceed the excess of the actuarial present value of the employee's accrued benefit (within the meaning of section 411(a)(7)) calculated as the annuity starting date using the applicable interest rate and the applicable mortality table under section 417(e) (or, if greater, the total amount of employee contributions) over the total of payments before the death of the employee; or

(3) As a result of dividend payments or other payments that result from actuarial gains (within the meaning of paragraph (e)(2) of this A–14), but only if —

(i) Actuarial gain is measured no less frequently than annually;

(ii) The resulting dividend payments or other payments are either paid no later than the year following the year for which the actuarial experience is measured or paid in the same form as the payment of the annuity over the remaining period of the annuity (beginning no later than the year following the year for which the actuarial experience is measured);

(iii) The actuarial gain taken into account is limited to actuarial gain from investment experience;

(iv) The assumed interest used to calculate such actuarial gains is not less than 3 percent; and

(v) The payments are not increasing by a constant percentage as described in paragraph (d)(1) of this A–14.

(e) *Definitions.* For purposes of this A–14, the following definitions apply —

(1) Total value being annuitized means —

(i) In the case of annuity payments under a section 403(a) annuity plan or under a deferred annuity purchased by a section 401(a) trust, the value of the employee's entire interest (within the meaning of A–12 of this section) being annuitized (valued as of the date annuity payments commence);

(ii) In the case of annuity payments under an immediate annuity contract purchased by a trust for a defined benefit plan qualified under section 401(a), the amount of the premium used to purchase the contract; and

(iii) In the case of a defined contribution plan, the value of the employee's account balance used to purchase an immediate annuity under the contract.

(2) Actuarial gain means the difference between an amount determined using the actuarial assumptions (*i.e.*, investment return, mortality, expense, and other similar assumptions) used to calculate the initial payments before adjustment for any increases and the amount determined under

the actual experience with respect to those factors. Actuarial gain also includes differences between the amount determined using actuarial assumptions when an annuity was purchased or commenced and such amount determined using actuarial assumptions used in calculating payments at the time the actuarial gain is determined.

(3) Total future expected payments means the total future payments expected to be made under the annuity contract as of the date of the determination, calculated using the Single Life Table in A–1 of §1.401(a)(9)–9 (or, if applicable, the Joint and Last Survivor Table in A–3 of in §1.401(a)(9)–9) for annuitants who are still alive, without regard to any increases in annuity payments after the date of determination, and taking into account any remaining period certain.

(4) Acceleration of payments means a shortening of the payment period with respect to an annuity or a full or partial commutation of the future annuity payments. An increase in the payment amount will be treated as an acceleration of payments in the annuity only if the total future expected payments under the annuity (including the amount of any payment made as a result of the acceleration) is decreased as a result of the change in payment period.

(f) *Examples.* Paragraph (c) of this A–14 is illustrated by the following examples:

*Example 1. Variable annuity.* A retired participant (Z1) in defined contribution plan X attains age 70 on March 5, 2005, and thus, attains age 70½ in 2005. Z1 elects to purchase annuity Contract Y1 from Insurance Company W in 2005. Contract Y1 is a single life annuity contract with a 10-year period certain. Contract Y1 provides for an initial annual payment calculated with an assumed interest rate (AIR) of 3 percent. Subsequent payments are determined by multiplying the prior year's payment by a fraction the numerator of which is 1 plus the actual return on the separate account assets underlying Contract Y1 since the preceding payment and the denominator of which is 1 plus the AIR during that period. The value of Z1's account balance in Plan X at the time of purchase is $105,000, and the purchase price of Contract Y1 is $105,000. Contract Y1 provides Z1 with an initial payment of $7,200 at the time of purchase in 2005. The total future expected payments to Z1 under Contract Y1 are $122,400, calculated as the initial payment of $7,200 multiplied by the age 70 life expectancy of 17 provided in the Single Life Table in A–1 of §1.401(a)(9)–9. Because the total future expected payments on the purchase date exceed the total value used to purchase Contract Y1 and payments may only increase as a result of actuarial gain, with such increases, beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity, distributions received by Z1 from Contract Y1 meet the requirements under paragraph (c)(3) of this A–14.

*Example 2. Participating annuity.* A retired participant (Z2) in defined contribution plan X attains age 70 on May 1, 2005, and thus, attains age 70½ in 2005. Z2 elects to purchase annuity Contract Y2 from Insurance Company W in 2005. Contract Y2 is a participating single life annuity contract with a 10-year period certain. Contract Y2 provides for level annual payments with dividends paid in a lump sum in the year after the year for which the actuarial experience is measured or paid out levelly beginning in the year after the year for which the actuarial gain is measured over the remaining lifetime and period certain, *i.e.*, the period certain ends at the same time as the original period certain. Dividends are determined annually by the Board of Directors of Company W based upon a comparison of actual actuarial experience to expected actuarial experience in the past year. The value of Z2's account balance in Plan X at the time of purchase is $265,000, and the purchase price of Contract Y2 is $265,000. Contract Y2 provides Z2 with an initial payment of $16,000 in 2005. The total future expected payments to Z2 under Contract Y2 are calculated as the annual initial payment of $16,000 multiplied by the age 70 life expectancy of 17 provided in the Single Life Table in A–1 of §1.401(a)(9)–9 for a total of $272,000. Because the total future expected payments on the purchase date exceeds the total value used to purchase Contract Y2 and payments may only increase as a result of actuarial gain, with such increases, beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity, distributions received by Z2 from Contract Y2 meet the requirements under paragraph (c)(3) of this A–14.

*Example 3. Participating annuity with dividend accumulation.* The facts are the same as in *Example 2* except that the annuity provides a dividend accumulation option under which Z2 may defer receipt of the dividends to a time selected by Z2. Because the dividend accumulation option permits dividends to be paid later than the end of the year following the year for which the actuarial experience is measured or as a stream of payments that only increase as a result of actuarial gain, with such increases beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity in *Example 2*, the dividend accumulation option does not meet the requirements of paragraph (c)(3) of this A–14. Neither does the dividend accumulation option fit within any of the other increases described in paragraph (c) of this A–14. Accordingly, the dividend accumulation option causes the contract, and consequently any distributions from the contract, to fail to meet the requirements of this A–14 and thus fail to satisfy the requirements of section 401(a)(9).

*Example 4. Participating annuity with dividends used to purchase additional death benefits.* The facts are the same as in *Example 2* except that the annuity provides an option under which actuarial gain under the contract is used to provide additional death benefit protection for Z2. Because this option permits payments as a result of actuarial gain to be paid later than the end of the year following the year for which the actuarial experience is measured or as a stream of payments that only increase as a result of actuarial gain, with such increases beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity in *Example 2*, the option does not meet the requirements of paragraph (c)(3) of this A–14. Neither does the option fit within any of the other increases described in paragraph (c) of this A–14. Accordingly, the addition of the option causes the contract, and consequently any distributions from the contract, to fail to meet the requirements of this A–14 and thus fail to satisfy the requirements of section 401(a)(9).

*Example 5. Annuity with a fixed percentage increase.* A retired participant (Z3) in defined contribution plan X attains age 70½ in 2005. Z3 elects to purchase annuity contract Y3 from Insurance Company W. Contract Y3 is a single life annuity contract with a 20-year period certain (which does not exceed the maximum period certain permitted under A–3(a) of this section) with fixed annual payments increasing 3 percent each year. The value of Z3's account balance in Plan X at the time of purchase is $110,000, and the purchase price of Contract Y3 is $110,000. Contract Y3 provides Z3 with an initial payment of $6,000 at the time of purchase in 2005. The total future expected payments to Z3 under Contract Y3 are $120,000, calculated as the initial annual payment of $6,000 multiplied by the period certain of 20 years. Because the total future expected payments on the purchase date exceed the total value used to purchase Contract Y3 and payments only increase as a constant percentage applied not less frequently than annually, distributions received by Z3 from Contract Y3 meet the requirements under paragraph (c)(1) of this A–14.

*Example 6. Annuity with excessive increases.* The facts are the same as in *Example 5* except that the initial payment is $5,400 and the annual rate of increase is 4 percent. In this example, the total future expected payments are $108,000, calculated as the initial payment of $5,400 multiplied by the period certain of 20 years. Because the total future expected payments are less than the total value of $110,000 used to purchase Contract Y3, distributions received by Z3 do not meet the requirements under paragraph (c) of this A–14 and thus fail to meet the requirements of section 401(a)(9).

*Example 7. Annuity with full commutation feature.* (i) A retired participant (Z4) in defined contribution Plan X attains age 78 in 2005. Z4 elects to purchase Contract Y4 from Insurance Company W. Contract Y4 provides for a single life annuity with a 10 year period certain (which does not exceed the maximum period certain permitted under A–3(a) of this section) with annual payments. Contract Y4 provides that Z4 may cancel Contract Y4 at any time before Z4 attains age 84, and receive, on his next payment due date, a final payment in an amount determined by multiplying the initial payment amount by a factor obtained from Table M of Contract Y4 using the Y4's age as of Y4's birthday in the calendar year of the final payment. The value of Z4's account balance in Plan X at the time of purchase is $450,000, and the purchase price of Contract Y4 is $450,000. Contract Y4 provides Z4 with an initial payment in 2005 of $40,000. The factors in Table M are as follows:

| Age at Final Payment | Factor |
|---|---|
| 79 | 10.5 |
| 80 | 10.0 |
| 81 | 9.5 |
| 82 | 9.0 |
| 83 | 8.5 |
| 84 | 8.0 |

(ii) The total future expected payments to Z4 under Contract Y4 are $456,000, calculated as the initial payment of 40,000 multiplied by the age 78 life expectancy of 11.4 provided in the Single Life Table in A–1 of §1.401(a)(9)–9. Because the total future expected payments on the purchase date exceed the total value being annuitized (*i.e.*, the $450,000 used to purchase Contract Y4), the permitted increases set forth in paragraph (c) of this A–14 are available. Furthermore, because the factors in Table M are less than the life expectancy of each of the ages in the Single Life Table provided in A–1 of §1.401(a)(9)–9, the final payment is always less than the total future expected payments. Thus, the final payment is an acceleration of payments within the meaning of paragraph (c)(4) of this A–14.

(iii) As an illustration of the above, if Participant Z4 were to elect to cancel Contract Y4 on the day before he was to attain age 84, his contractual final payment would be $320,000. This amount is determined as $40,000 (the annual payment amount due under Contract Y4) multiplied by 8.0 (the factor in Table M for the next payment due date, age 84). The total future expected payments under Contract Y4 at age 84 before the final payment is $324,000, calculated as the initial payment amount multiplied by 8.1, the age 84 life expectancy provided in the Single Life Table in A–1 of §1.401(a)(9)–9. Because $320,000 (the total future expected payments under the annuity contract, including the amount of the final payment) is less than $324,000 (the total future expected payments under the annuity contract, determined before the election), the final payment is an acceleration of payments within the meaning of paragraph (c)(4) of this A–14.

*Example 8. Annuity with partial commutation feature*. (i) The facts are the same as in *Example 7* except that the annuity provides Z4 may request, at any time before Z4 attains age 84, an ad hoc payment on his next payment due date with future payments reduced by an amount equal to the ad hoc payment divided by the factor obtained from Table M (from *Example 7*) corresponding to Z4's age at the time of the ad hoc payment. Because, at each age, the factors in Table M are less than the corresponding life expectancies in the Single Life Table in A–1 of §1.401(a)(9)–9, total future expected payments under Contract Y4 will decrease after an ad hoc payment. Thus, ad hoc distributions received by Z4 from Contract Y4 will satisfy the requirements under paragraph (c)(4) of this A–4.

(ii) As an illustration of paragraph (i) of this *Example 8*, if Z4 were to request, on the day before he was to attain age 84, an ad hoc payment of $100,000 on his next payment due date, his recalculated annual payment amount would be reduced to $27,500. This amount is determined as $40,000 ( the amount of Z4's next annual payment) reduced by $12,500 (his $100,000 ad hoc payment divided by the Table M factor at age 84 of 8.0). Thus, Z4's total future expected payments after the ad hoc payment (and including the ad hoc payment) are equal to $322,750 ($100,000 plus $27,500 multiplied by the Single Life Table value of 8.1). Note that this $322,750 amount is less than the amount of Z4's total future expected payments before the ad hoc payment ($324,000, determined as $40,000 multiplied by 8.1), and the requirements under paragraph (c)(4) of this A–4 are satisfied.

*Example 9. Annuity with excessive increases*. (i) A retired participant (Z5) in defined contribution plan X attains age 70½ in 2005. Z5 elects to purchase annuity Contract Y5 from Insurance Company W in 2005 with a premium of $1,000,000. Contract Y5 is a single life annuity contract with a 20-year period certain. Contract Y5 provides for an initial payment of $200,000, a second payment one year from the time of purchase of $40,000, and 18 succeeding annual payments each increasing at a constant percentage rate of 4.5 percent from the preceding payment.

(ii) Contract Y5 fails to meet the requirements of section 401(a)(9) because the total future expected payments without regard to any increases in the annuity payment, calculated as $200,000 in year one and $40,000 in each of years two through twenty, is only $960,000 (*i.e.*, an amount that does not exceed the total value used to purchase the annuity).

Q–15. Are there special rules applicable to payments made under a defined benefit plan or annuity contract to a surviving child?

A–15. Yes, Pursuant to section 401(a)(9)(F), payments under a defined benefit plan or annuity contract that are made to an employee's child until such child reaches the age of majority (or dies, if earlier) may be treated, for purposes of section 401(a)(9), as if such payments were made to the surviving spouse to the extent they become payable to the surviving spouse upon cessation of the payments to the child. For purposes of the preceding sentence, a child may be treated as having not reached the age of majority if the child has not completed a specified course of education and is under the age of 26. In addition, a child who is disabled within the meaning of section 72(m)(7) when the child reaches the age of majority may be treated as having not reached the age of majority so long as the child continues to be disabled. Thus, when payments described in this paragraph A–15 become payable to the surviving spouse because the child attains the age of majority, recovers from a disabling illness, dies, or completes a specified course of education, there is not an increase in benefits under A–1 of this section. Likewise, the age of child receiving such payments is not taken into consideration for purposes of the minimum incidental benefit requirement of A–2 of this section.

Q–16. Will a governmental plan within the meaning of section 414(d) fail to satisfy section 401(a)(9) if annuity payments under the plan do not satisfy this section?

A–16. (a) Except as provided in paragraph (b) of this A–16, annuity payments under a governmental plan within the meaning of section 414(d) must satisfy this section.

(b) In the case of an annuity distribution option provided under the terms of a governmental plan as in effect on April 17, 2002, the plan will not fail to satisfy section 401(a)(9) merely because the annuity payments do not satisfy the requirements A–1 through A–15 of this section, provided the distribution option satisfies section 401(a)(9) based on a reasonable and good faith interpretation of the provisions of section 401(a)(9).

Q–17. What are the rules for determining required minimum distributions for defined benefit plans and annuity contracts for calendar years 2003, 2004, and 2005?

A–17. A distribution from a defined benefit plan or annuity contract for calendar years 2003, 2004, and 2005 will not fail to satisfy section 401(a)(9) merely because the payments do not satisfy A–1 through A–16 of this section, provided the payments satisfy section 401(a)(9) based on a reasonable and good faith interpretation of the provisions of section 401(a)(9). For governmental plans, this reasonable good faith standard extends to the end of the calendar year that contains the 90th day after the opening of the first legislative session of the legislative body with the authority to amend the plan that begins on or after June

15, 2004, if such 90th day is later than December 31, 2005.

**§1.401(a)(9)–6T [Removed]**

Par. 4. Section 1.401(a)(9)–6T is removed.

Par. 5. In §1.401(a)(9)–8 A–2, the first sentence in paragraph (a)(2) is revised to read as follows:

*§1.401(a)(9)–8 Special rules.*

* * * * *

A–2 * * *

(a) * * *

(2) If the employee's benefit in a defined contribution plan is divided into separate accounts and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts of the employee under the plan, for years subsequent to the calendar year containing the date as of which the separate accounts were established, or date of death if later, such separate account under the plan is not aggregated with the other separate accounts under the plan in order to determine whether the distributions from such separate account under the plan satisfy section 401(a)(9). * * *

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Mark E. Matthews,
*Deputy Commissioner for Services and Enforcement.*

Approved June 1, 2004.

Gregory F. Jenner,
*Acting Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on June 14, 2004, 8:45 a.m., and published in the issue of the Federal Register for June 15, 2004, 69 F.R. 33288)

## Section 861.—Income From Sources Within the United States

A revenue procedure provides a method for allocating a pension payment to sources within and without the United States when a domestic trust under a qualified defined benefit plan makes a payment with respect to a nonresident alien participant and the actual amounts of employer contributions made to the plan for the benefit of such participant are not known. See Rev. Proc. 2004-37, page 1099.

## Section 862.—Income From Sources Without the United States

A revenue procedure provides a method for allocating a pension payment to sources within and without the United States when a domestic trust under a qualified defined benefit plan makes a payment with respect to a nonresident alien participant and the actual amounts of employer contributions made to the plan for the benefit of such participant are not known. See Rev. Proc. 2004-37, page 1099.

## Section 871.—Tax on Nonresident Alien Individuals

A revenue procedure provides a method for allocating a pension payment to sources within and without the United States when a domestic trust under a qualified defined benefit plan makes a payment with respect to a nonresident alien participant and the actual amounts of employer contributions made to the plan for the benefit of such participant are not known. See Rev. Proc. 2004-37, page 1099.

## Section 1441.—Withholding of Tax on Nonresident Aliens

A revenue procedure provides a method for allocating a pension payment to sources within and without the United States when a domestic trust under a qualified defined benefit plan makes a payment with respect to a nonresident alien participant and the actual amounts of employer contributions made to the plan for the benefit of such participant are not known. See Rev. Proc. 2004-37, page 1099.

1.1 M ........ moves to amend S.F. No. 70; H.F. No. 40, as follows:

1.2 Page 2, line 6, after "required" insert "as of the current June 30"

1.3 Page 2, line 9, strike "commission-retained" and after "actuary" insert "retained
1.4 under section 356.214" and strike "as of the current June 30"

1.5 Page 2, line 34, strike "commission-retained" and after "actuary" insert "retained
1.6 under section 356.214"

1.7 Page 3, line 14, strike "pursuant to" and insert "under"

1.8 Page 4, line 5, strike "commission-retained"

1.9 Page 4, line 6, after "actuary" insert "retained under section 356.214"

1.10 Page 4, line 7, strike "commission-retained" and after "actuary" insert "retained
1.11 under section 356.214"

1.12 Page 4, after line 31, insert:

1.13 "Sec. 2. **EFFECTIVE DATE.**

1.14 Section 1 is effective on the day following final enactment."

1.1 M ........ moves to amend S.F. No. 70; H.F. No. 40, as follows:

1.2 Page 4, line 20, delete "five" and insert "........."

1.1 M ........ moves to amend S.F. No. 70; H.F. No. 40, as follows:

1.2 Page 4, line 10, strike "and"

1.3 Page 4, line 20, before the underscored period insert "; and

1.4 (3) "Eligible" required reserves, if any, in excess of amounts needed due to the
1.5 maximum permitted full postretirement adjustment percentage authorized under clause (2)
1.6 are declared to be excess reserves, and must be allocated to the next year"

1.1 M ........ moves to amend S.F. No. 70; H.F. No. 40, as follows:

1.2 Page 4, line 10, strike "and"

1.3 Page 4, line 20, before the underscored period insert "; and

1.4 (3) "Eligible" required reserves, if any, in excess of amounts needed due to the
1.5 maximum permitted full postretirement adjustment percentage authorized under clause
1.6 (2) are declared to be excess reserves, and must be allocated in equal amounts to each of
1.7 the next four years"

**Senator Betzold introduced--**

**S.F. No. 70:** Referred to the Committee on Agriculture, Veterans and Gaming.

1 A bill for an act

2 relating to retirement; limiting certain
3 postretirement adjustments for the Minnesota
4 postretirement investment fund; amending Minnesota
5 Statutes 2004, section 11A.18, subdivision 9.

6 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MINNESOTA:

7 Section 1. Minnesota Statutes 2004, section 11A.18,
8 subdivision 9, is amended to read:

9 Subd. 9. [CALCULATION OF POSTRETIREMENT ADJUSTMENT.] (a)
10 Annually, following June 30, the state board shall use the
11 procedures in paragraphs (b), (c), and (d) to determine whether
12 a postretirement adjustment is payable and to determine the
13 amount of any postretirement adjustment.

14 (b) If the Consumer Price Index for urban wage earners and
15 clerical workers all items index published by the Bureau of
16 Labor Statistics of the United States Department of Labor
17 increases from June 30 of the preceding year to June 30 of the
18 current year, the state board shall certify the percentage
19 increase. The amount certified must not exceed the lesser of
20 the difference between the preretirement interest assumption and
21 postretirement interest assumption in section 356.215,
22 subdivision 8, paragraph (a), or 2.5 percent. For the
23 Minneapolis Employees Retirement Fund, the amount certified must
24 not exceed 3.5 percent.

25 (c) In addition to any percentage increase certified under

1 paragraph (b), the board shall use the following procedures to
2 determine if a postretirement adjustment is payable under this
3 paragraph:
4 (1) The state board shall determine the market value of the
5 fund on June 30 of that year;
6 (2) The amount of reserves required for the annuity or
7 benefit payable to an annuitant and benefit recipient of the
8 participating public pension plans or funds must be determined
9 by the commission-retained actuary as of the current June 30.
10 An annuitant or benefit recipient who has been receiving an
11 annuity or benefit for at least 12 full months as of the current
12 June 30 is eligible to receive a full postretirement
13 adjustment. An annuitant or benefit recipient who has been
14 receiving an annuity or benefit for at least one full month, but
15 less than 12 full months as of the current June 30, is eligible
16 to receive a partial postretirement adjustment. Each fund shall
17 report separately the amount of the reserves for those
18 annuitants and benefit recipients who are eligible to receive a
19 full postretirement benefit adjustment. This amount is known as
20 "eligible reserves." Each fund shall also report separately the
21 amount of the reserves for those annuitants and benefit
22 recipients who are not eligible to receive a postretirement
23 adjustment. This amount is known as "noneligible reserves."
24 For an annuitant or benefit recipient who is eligible to receive
25 a partial postretirement adjustment, each fund shall report
26 separately as additional "eligible reserves" an amount that
27 bears the same ratio to the total reserves required for the
28 annuitant or benefit recipient as the number of full months of
29 annuity or benefit receipt as of the current June 30 bears to 12
30 full months. The remainder of the annuitant's or benefit
31 recipient's reserves must be separately reported as additional
32 "noneligible reserves." The amount of "eligible" and
33 "noneligible" required reserves must be certified to the board
34 by the commission-retained actuary as soon as is practical
35 following the current June 30;
36 (3) The state board shall determine the percentage increase

1 certified under paragraph (b) multiplied by the eligible
2 required reserves, as adjusted for mortality gains and losses
3 under subdivision 11, determined under clause (2);
4 (4) The state board shall add the amount of reserves
5 required for the annuities or benefits payable to annuitants and
6 benefit recipients of the participating public pension plans or
7 funds as of the current June 30 to the amount determined under
8 clause (3);
9 (5) The state board shall subtract the amount determined
10 under clause (4) from the market value of the fund determined
11 under clause (1);
12 (6) The state board shall adjust the amount determined
13 under clause (5) by the cumulative current balance determined
14 pursuant to clause (8) and any negative balance carried forward
15 under clause (9);
16 (7) A positive amount resulting from the calculations in
17 clauses (1) to (6) is the excess market value. A negative
18 amount is the negative balance;
19 (8) The state board shall allocate one-fifth of the excess
20 market value or one-fifth of the negative balance to each of
21 five consecutive years, beginning with the fiscal year ending
22 the current June 30; and
23 (9) To calculate the postretirement adjustment under this
24 paragraph based on investment performance for a fiscal year, the
25 state board shall add together all excess market value allocated
26 to that year and subtract from the sum all negative balances
27 allocated to that year. If this calculation results in a
28 negative number, the entire negative balance must be carried
29 forward and allocated to the next year. If the resulting amount
30 is positive, a postretirement adjustment is payable under this
31 paragraph. The board shall express a positive amount as a
32 percentage of the total eligible required reserves certified to
33 the board under clause (2).
34 (d) The state board shall determine the amount of any
35 postretirement adjustment which is payable using the following
36 procedure:

1 (1) The total "eligible" required reserves as of the first
2 of January next following the end of the fiscal year for the
3 annuitants and benefit recipients eligible to receive a full or
4 partial postretirement adjustment as determined by clause (2)
5 must be certified to the state board by the commission-retained
6 actuary. The total "eligible" required reserves must be
7 determined by the commission-retained actuary on the assumption
8 that all annuitants and benefit recipients eligible to receive a
9 full or partial postretirement adjustment will be alive on the
10 January 1 in question; and
11 (2) The state board shall add the percentage certified
12 under paragraph (b) to any positive percentage calculated under
13 paragraph (c). The board shall not subtract from the percentage
14 certified under paragraph (b) any negative amount calculated
15 under paragraph (c). The sum of these percentages must be
16 carried to five decimal places and must be certified to each
17 participating public pension fund or plan as the full
18 postretirement adjustment percentage. The full postretirement
19 adjustment percentage certified to each participating public
20 pension plan or fund must not exceed five percent.
21 (e) A retirement annuity payable in the event of retirement
22 before becoming eligible for Social Security benefits as
23 provided in section 352.116, subdivision 3; 353.29, subdivision
24 6; or 354.35 must be treated as the sum of a period certain
25 retirement annuity and a life retirement annuity for the
26 purposes of any postretirement adjustment. The period certain
27 retirement annuity plus the life retirement annuity must be the
28 annuity amount payable until age 62 or 65, whichever applies. A
29 postretirement adjustment granted on the period certain
30 retirement annuity must terminate when the period certain
31 retirement annuity terminates.