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IRC SECTION 415(b) & REPLACEMENT BENEFIT PLAN FACT SHEET

What is Internal Revenue Code Section 415(b)?

Internal Revenue Code Section 415(b) (IRC 415) is a federal provision that limits the amount of annual retirement benefit an individual can receive from a tax-qualified defined benefit pension plan such as the California Public Employees' Retirement System (CalPERS). The annual retirement benefits payable from the CalPERS retirement plan are subject to the dollar limits imposed by IRC 415.

This law was enacted to prevent employers from using tax-qualified defined benefit plans as tax shelters. The CalPERS retirement plan may lose its tax-exempt status if it fails to comply with IRC 415.

Internal Revenue Code Section IRC 415(b) Retirement Benefit Limit

IRC 415 places a dollar limit on the annual retirement benefit (allowance) that can be received from a tax-qualified pension plan such as CalPERS.

Overview

- The 2014 annual dollar limit is \$210,000 for retirees aged 62-65. (These ages are designated as "normal retirement age" by the Social Security Administration.)
- Determination of whether a CalPERS member's retirement benefit will be subject to the IRC 415 limit can only be made at retirement.
- For members who retire between the ages of 50-61, the annual dollar limit is lower, adjusted to be the actuarial equivalent as if the member were aged 62-65 at retirement.
- Retirees whose defined benefit allowances are limited under IRC 415 will receive replacement benefits from a separate fund through the CalPERS Replacement Benefit Plan (RBP), as permitted by California retirement law effective January 1, 2013¹. Please see page 3, "Who is Eligible to Participate in the RBP?"

¹ Effective January 1, 2013 only retirees with a CalPERS membership date prior to January 1, 2013 are eligible for the Replacement Benefit Plan in retirement.

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How is a retiree's IRC 415 annual dollar limit determined?

The annual dollar limit is calculated using the following factors:

- date of membership in the CalPERS defined benefit pension plan
- age at retirement
- tax-deferred member contributions
- rollover and post-tax contributions used to purchase service credit

The annual dollar limit is lower:

- For a benefit in any form other than a life-only annuity (unmodified allowance) or a qualified joint and survivor annuity (an allowance where 50% or more of the retiree's allowance is payable to a spouse upon the retiree's death).
- If retirement occurs before age 62.

The age 62-65 annual dollar limit is used instead of the actual age dollar limit:

- For the allowances of police officer and firefighter members with 15 or more years of service as full-time employees of a police department or a fire department providing police protection, firefighting services, or emergency medical services. Service with employers other than a police or fire department, such as correctional facilities, does not qualify.
- For a survivor's allowance payable due to the pre-retirement death of a member.
- For disability retirement before age 62.

What is the process for applying the IRC 415 limit to a retirement allowance?

It cannot be determined before actual retirement whether a member's retirement allowance will be limited by IRC 415. The allowance is tested as follows:

Screening: All retirement allowances are automatically screened to identify those needing testing for the IRC 415 limit. This screening is performed at retirement for all new allowances. Beginning in 2014, this screening will be performed annually on all retirement allowances.

Testing process: Once a screened allowance is identified for testing, an actuarial program determines if the allowance must be limited and, if so, calculates the annual dollar limit.

Section 415 & Replacement Benefit Plan Fact Sheet

If the allowance must be limited, the test determines:

- **Dollar Limit:** The maximum annual amount of retirement allowance payable to the retiree from the California Public Employees' Retirement Fund (PERF).
- **Replacement Benefit:** This is the annual allowance amount in excess of the dollar limit. This amount must be paid to CalPERS by the retiree's former employers and is then paid to the retiree through the Replacement Benefit Plan (RBP).

Grandfather Provision

There is an IRC 415 "grandfather" provision that exempts a retirement allowance from the dollar limit only if the retiree's former employers did not provide any retirement benefit improvement effective on or after October 14, 1987. Examples of benefit improvements are a change in retirement formula or a change from a three-year to a one-year final compensation, etc.

CalPERS REPLACEMENT BENEFIT PLAN (RBP)

What is the Replacement Benefit Plan?

The Replacement Benefit Plan (RBP) is a plan that allows for replacement of the annual allowance that exceeds the IRC 415 dollar limit. The RBP is funded by the retiree's former employers. CalPERS invoices and receives the replacement benefit amounts from the affected employers and then disburses payment to the retiree.

Every CalPERS employer must participate in the RBP in accordance with Government Code IRC 21761. The RBP statutes are Government Code IRC s 21750 – 21765 and the RBP regulations are California Code of Regulations 589 – 589.10.

Who is eligible to participate in the RBP?

CalPERS retirees who became CalPERS members prior to January 1, 2013 and whose combination of reportable compensation, benefit factor, retirement contributions and service credit cause their annual retirement allowances to exceed the IRC 415 dollar limits are eligible to participate in the RBP.

How does the RBP work?

When a retiree's annual retirement allowance exceeds the IRC 415 dollar limit CalPERS invoices the retiree's former employers for the amounts payable from the RBP. The invoice payments are deposited into the Replacement Benefit Fund (RBF). CalPERS issues payment from the RBF to the retiree. Payment by the employers into the RBF is required before any replacement benefit can be issued to a retiree.

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How is the replacement benefit taxed?

The income received through the Replacement Benefit Plan (RBP) is a wage under federal tax law. The replacement benefit is subject to the Federal Insurance Contributions Act (FICA) tax, which consists of the Old Age, Survivors and Disability Insurance (OASDI) Social Security tax and the Hospital Insurance/Medicare (Medicare) tax. The FICA tax payment is due only in the first year an allowance is limited. The replacement benefit is subject to these federal taxes if, while employed, the individual's earnings were subject to these taxes. The taxes are computed as follows:

1. CalPERS actuaries calculate the present value² of the replacement benefit.
2. Taxes are computed on the present value as follows:
 - Social Security tax rate for employees is 6.2%, up to maximum earnings of \$117,000 for 2014.
 - Social Security tax rate for employers is 6.2% up to maximum earnings of \$117,000 for 2014.
 - Medicare tax rate is 1.45% for employers and employees with no maximum earnings amount.
3. CalPERS invoices the employers for their taxes.
4. CalPERS deducts the employee taxes from the retiree's replacement benefit. FICA taxes are paid before any benefits are issued to the retiree.
5. CalPERS remits both employee and employer taxes to the Internal Revenue Service.
6. At the end of the tax year, CalPERS issues the retiree a W-2 tax form for the replacement benefits paid.

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Important: *The information included in this document is general. The California Public Employees' Retirement Law and the Internal Revenue Code are complex and subject to change. If there is a conflict between the law and the information in this document, the law supersedes the information in this document.*

²Present value is the discounted amount the retiree will receive in lifetime replacement benefits. This discounted amount is based on CalPERS' valuation interest rate, the post-retirement mortality table, and the Cost-of-Living Adjustment assumption. For tax purposes, the present value is treated as if it were fully paid in the year the replacement benefit becomes payable.