Benefit Services Division
P.O. Box 1652
Sacramento, CA 95812-1652
888 CalPERS (or **888**-225-7377)
TDD - (916) 795-3240; FAX (916) 795-0385

IRC SECTION 415 & CalPERS REPLACEMENT BENEFIT PLAN FACT SHEET

What is Internal Revenue Code Section 415?

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

The 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 Section 415.

Important

The information included here 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 will supersede the information in this document.

Internal Revenue Code Section 415(b) Retirement Benefit Limit

IRC Section 415(b) places a dollar limit on the annual benefit that can be received from a tax-qualified pension plan such as CalPERS. Under Section 415(b), the maximum annual retirement benefit payable at Social Security "normal retirement age" is $195,000 for calendar year 2010. This dollar limit is set every year by the Internal Revenue Service. Determination of whether your retirement benefit will be subject to this limit can only be made at retirement.

At a glance

Section 415(b) limits the amount of annual retirement benefit that may be paid from the CalPERS defined benefit plan. The limit for a given individual is determined by the limit

established by the Internal Revenue Service in effect during the calendar year in which the individual retires.

- The 2010 annual benefit limit is $195,000 for members aged 62 to 65.
- For members who retire between the ages of 50 and 61, the annual benefit limit is lower (adjusted to be the actuarial equivalent for the member as if the member had retired between 62 and 65 years of age). For members who retire after age 65, the annual benefit limit is higher (adjusted to be the actuarial equivalent for the member as if the member was aged 62-65 at retirement).
- The Section 415(b) annual benefit limit may be adjusted by the IRS annually for Cost-of-Living Adjustments.
- Determination of whether a member's retirement benefit will be subject to the Section 415(b) limit can only be made at retirement.
- Qualified police officer and firefighter members with at least 15 years of service as full-time employees of any police department or fire department to provide police protection, firefighting services, or emergency medical services are tested against the annual dollar limit for age 62, not their actual age.
- Retirees whose defined benefit allowances are determined to be limited under Section 415(b) will receive their entire retirement entitlement. The annual total benefit that exceeds their Section 415(b) limit will be issued in quarterly payments as "replacement benefits" from a separate fund through the CalPERS Replacement Benefit Plan.

What is the Section 415(b) benefit limit?

The Section 415(b) annual benefit limit is a dollar amount an individual can receive in a retirement allowance from the CalPERS defined benefit plan. The individual's annual benefit limit amount is determined by the dollar limits in effect for the calendar year in which he/she retires.

The dollar limit applies to benefits attributable to:

- employer contributions and
- tax-deferred member contributions

The dollar limit applicable to a member's retirement allowance may be adjusted to reflect variables such as:

- date of membership in the CalPERS defined benefit plan
- age at the time of retirement

Annual benefits (retirement allowance) attributable to rollover contributions and post-tax contributions may be excluded from the calculation of the annual benefit dollar limit.

The dollar limit for the annual benefit is lower:

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

- If retirement occurs before age 62.
- If a member has less than ten years of CalPERS service credit at the time of retirement.

The dollar limit for the annual benefit is higher if retirement occurs after age 65.

How is it determined whether a retirement allowance must be limited?

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

Screening: At retirement, the highest annual benefit allowance payable for a member's lifetime alone or the "unmodified allowance" is screened against the current year's Section 415(b) dollar limit to determine if testing is required. If the unmodified allowance exceeds the current year's Section 415(b) dollar limit, then the retirement allowance is "tested" to see if it will be limited.

Testing process: Once a screened allowance is identified for testing, an actuarial program is used to test the allowance for limiting. This program incorporates the applicable variables mentioned in "What is the Section 415(b) benefit limit?" and determines whether or not the allowance must be limited.

If the allowance must be limited, the test then determines:

- The maximum amount of retirement allowance payable to the retiree each year of his/her retirement from the California Public Employees' Retirement Fund (PERF).
- The amount in excess of the limit that will be payable as replacement benefits through the CalPERS Replacement Benefit Plan.

When can an adjustment be made to the age-based limit?

Under the age-based limits, the Section 415(b) limit amount is lower for members retiring before age 62 and it is higher for members retiring after age 65.

In the following cases, the age 62-65 dollar limit amount is used instead of actual age:

- For qualified police officer, firefighter members including California Highway Patrol, Local Safety and Peace Officer/Firefighter members with at least 15 years of service as full-time employees of any police department or fire department to provide police protection, firefighting services, or emergency medical services ;
- For a survivor's allowance payable due to the pre-retirement death of a member;
- For disability retirement before age 62.

Grandfather Provision

The "grandfather" provision exempts all or a portion of a retirement allowance from the Section 415(b) dollar limit under the following conditions:

- The individual became a CalPERS member before January 1, 1990 and the employer has not provided a retirement benefit improvement since October 14, 1987. If applicable, the entire retirement allowance is payable from the California Public Employees' Retirement Fund (PERF), regardless of the Section 415(b) dollar limit.

- The individual became a CalPERS member before January 1, 1990 and the employer has provided a benefit improvement since October 14, 1987. If applicable, the portion of the retirement allowance attributable to the benefit improvement is subject to the dollar limit.

Examples of benefit improvements are a change in retirement formula, a change from three-year to one-year final compensation, etc.

THE CalPERS REPLACEMENT BENEFIT PLAN (RBP)

What is the RBP?

The Replacement Benefit Plan (RBP) is a plan that allows for "replacement" of the annual benefit allowance amount that exceeds the Section 415(b) limit with wages. Its purpose is to "make whole" the retirement allowances limited by Section 415(b).

The RBP is funded by the employer. CalPERS invoices and collects the replacement benefit amount from the affected employer and then disburses it to affected retirees as wages in quarterly payments within the calendar year.

Who is eligible to participate in the RBP?

All members whose combination of reportable compensation, benefit factor and service credit cause their benefits to exceed the Section 415(b) benefit limits are eligible to participate in the RBP.

How does the RBP work?

When an individual's retirement allowance exceeds the Section 415(b) dollar limit:

1. CalPERS invoices the employer for the amount payable from the RBP.

2. The employer's payment is required before any payment can be issued to the retiree.
3. Assuming employer payments have been made, replacement benefit payments are made from the RBP to the retiree quarterly, at the beginning of March, June, September, and December.

What is the employer's obligation?

In general, the RBP is designed to be cost-neutral to employers.

Upon payment of the invoiced amount to the Replacement Benefit Plan (RBP), the employer can take a credit for the amount paid for replacement benefits, less applicable FICA taxes, against their employer contributions currently due to the Public Employees' Retirement Fund (PERF).

What if the employer contributions due to the PERF are less than the invoiced amount?

To the extent practicable, payments to the RBP are required to be made from amounts that would have been contributed by the employer to CalPERS. However, in certain infrequent circumstances, it is possible that an employer's contributions due to the PERF could be less than the RBP invoiced amount. In that situation, the employer must pay the RBP amount as invoiced to cover the amount owed to the retiree. Please see CalPERS' Replacement Benefit Plan regulations for a description of employer payments required to fund the RBP. (Title 2 CCR section 589 *et seq.*)

How is the replacement benefit taxed?

The income received by a retiree through the Replacement Benefit Plan (RBP) is treated by the federal government as a wage. A member's replacement benefit will be subject to Federal Insurance Contributions Act (FICA) tax, which consists of the Old Age, Survivors and Disability Insurance (Social Security) and the Hospital Insurance/Medicare (Medicare) tax, if his or her earnings while employed were subject to these taxes. If subject, this FICA tax payment is due only in the first year of a member's retirement. The taxes are computed as follows:

1. CalPERS actuaries calculate the present value* of the replacement benefit.

2. Taxes are computed for this present value amount:
   - Social Security tax rate is 6.2% up to a maximum earnings amount ($102,000 maximum for 2010)
   - Medicare tax rate is 1.45% with no maximum earnings amount

3. CalPERS invoices the employer for the taxes due. Employers cannot take a credit against their contributions for these taxes.

4. CalPERS deducts the total taxes payable from the retiree's replacement benefit.

5. CalPERS remits the taxes to the Internal Revenue Service.

6. At the end of the tax year, CalPERS issues each retiree a tax form W2 for the replacement benefits paid.

As noted, FICA taxes are paid before any benefits from the RBP are paid to the retiree.

*Present value is the discounted amount the member 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.

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