Practical Solutions for Defined Contribution Plans

(July 2017)

Developing and Estimating the Annual Qualified Plan Limit Increases

Each year the IRS announces its annual qualified plan limit increases in late October for the next calendar year. See the most recent release at: www.irs.gov/pub/irs-drop/n-16-62.pdf For most companies, a late October release is sufficient for their next year planning initiatives. However, for those who require the estimates before late October, the process of developing a best guess of the inflation based cost-of-living increases can be overwhelming.

The Average CPI Number

The annual qualified plan benefit limit increases are currently based on the original benefit increase law, or the effective date for the increases for inflation, and the "law-to-date" change in the average of the July, August and September Consumer Price Index for All Urban Consumers (the "average CPI number").

After determining the current year's average CPI number in late October, the IRS applies their CPI increase percentage procedures, similar to those under section 215(i)(2)(A) of the Social Security Act, to adjust the annual benefit limits. The difficulty in the calculation involves the determination of the base year average CPI number used in those applicable CPI increase percentage calculations. The base year average CPI number is the original average CPI number established when the law was enacted, or became effective, and not the prior year's average CPI number.

For example:

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") established new 402(g)(1) Deferral Limits of $11,000 in 2002, which would increase by $1,000 per year until reaching $15,000 in 2006. In 2006 and beyond, the 402(g)(1) Deferral Limit increases would be indexed to inflation and increase in $500 increments.

In 2005, the year before the legislated inflation increases, the base year average CPI number for the 402(g)(1) deferral limits ("deferral limit") was 196.9. In 2016, the average CPI number was determined to be 240.968, making the law-to-date CPI increase factor equal to 1.224, (240.968 / 196.9 = 1.224).

To determine the 2017 deferral limit, we took the original 2005 deferral limit, $15,000, times 1.224 (the law-to-date CPI increase from 2005 to 2016) and arrived at $18,360. Rounding down to the nearest $500 increase increment, we reduce the $18,360 to $18,000. We can see that the incremental $500 increase was not possible this year, so the 2017 deferral limit will stay at the 2016 deferral limit, $18,000.

The Original Annual Limits

For the main group of qualified plans, the original annual limits were established or modified at three different points in time:

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In <u>1996/1997</u> the Highly Compensated Limit was indexed to inflation:

- 414(q)(1)(B) Highly Compensated Employee Limit ($80,000)

In <u>2001/2002</u> the following Annual Limits were indexed to inflation:

- 401(a)(17) Annual Compensation Limit ($200,000)
- 415(b)(1)(A) Defined Benefit Limit ($140,000)
- 415(c)(1)(A) Defined Contribution Limit ($40,000)
- 416(i)(1)(A)(i) Key Employee Limit ($130,000)

In 2005/2006 the following Annual Limits were indexed to inflation:

- 402(g)(1) Deferral Limit ($15,000)
- 414(v)(2)(B)(i) Catchup Limit ($5,000)
- 414(q)(1)(B) Highly Compensated Employee Limit ($80,000)

The Original Base Year CPI Average and the 2017 Annual Limit Calculations

Once we determined the original base year CPI averages (Column 2 below), we used the July, August and September 2016 CPI numbers (Column 1 below), along with the annual limit increment increases (in the footnotes below) and the original base year limit (Column 4 below), to determine the new annual limits for 2017 (Column 6 below).

To determine the new 2017 Annual Limits, for the 1996/1997 group:

2017 Annual Limit Calculations for Annual Limits Originally Developed in 1997/1998	(1) New 2016 Jul/Aug/Sep CPI Average	(2) Orig. 1996 Jul/Aug/Sep Base Year CPI Average	(3) Total Law-to-Date CPI Increase	(4) Orig. 1997 Base Year Limit	(5) Orig. 1997 Base Year Limit x Total Law-to-Date CPI Increase – Est.	(6) New 2017 Annual Limit
Calculations	N/A	N/A	(1) / (2)	N/A	(4) x (3)	(5) Limited
414(q)(1)(B) HCE Limit[1]	240.968	157.4	1.531	$80,000	$122,480	$120,000[1]

[1] Limited to $5,000 increment increases (rounded down to nearest $5,000 increment)

To determine the new 2017 Annual Limits, for the 2001/2002 group of limits:

2017 Annual Limit Calculations for Annual Limits Originally Developed in 2001/2002	(1) New 2016 Jul/Aug/Sep CPI Average	(2) Orig. 2001 Jul/Aug/Sep Base Year CPI Average	(3) Total Law-to-Date CPI Increase	(4) Orig. 2002 Base Year Limit	(5) Orig. 2002 Base Year Limit x Total Law-to-Date CPI Increase – Est.	(6) New 2017 Annual Limits
Calculations	N/A	N/A	(1) / (2)	N/A	(4) x (3)	(5) Limited
401(a)(17) Compensation Limit[1]	240.968	177.8	1.355	$200,000	$271,000	$270,000[1]
415(b)(1)(A) Defined Benefit Limit[1]	240.968	177.8	1.355	$160,000	$216,800	$215,000[1]
415(c)(1)(A) Defined Cont. Limit[2]	240.968	177.8	1.355	$40,000	$54,200	$54,000[2]
416(i)(1)(A)(i) Key Employee Limit[1]	240.968	177.8	1.355	$130,000	$176,150	$175,000[1]

[1] Limited to $5,000 increment increases (rounded down to nearest $5,000 increment)
[2] Limited to $1,000 increment increases (rounded down to nearest $1,000 increment)

To determine the new 2017 Annual Limits, for the 2005/2006 group:

2017 Annual Limit Calculations for Annual Limits Originally Developed in 2005/2006	(1) New 2016 Jul/Aug/Sep CPI Average	(2) Orig. 2005 Jul/Aug/Sep Base Year CPI Average	(3) Total Law-to-Date CPI Increase	(4) Orig. 2006 Base Year Limit	(5) Orig. 2006 Base Year Limit x Total Law-to-Date CPI Increase – Est.	(6) New 2017 Annual Limit
Calculations	N/A	N/A	(1) / (2)	N/A	(4) x (3)	(5) Limited
402(g)(1) Deferral Limit[1]	240.968	196.9	1.224	$15,000	$18,360	$18,000[1]
414(v)(s)(B)(i) Catchup Limit[1]	240.968	196.9	1.224	$5,000	$6,120	$6,000[1]

[1] Limited to $500 increment increases (rounded down to nearest $500 increment)

Annual Limit "Increment" Increases

Note that the annual limit increases are not limited to one times the annual increment increase amounts. The annual increment limit increases are the multiples of and not maximum increases. Notice in the IRS summary table www.irs.gov/pub/irs-tege/cola_table.pdf that the 401(a)(17) Compensation Limit jumped from $230,000 in 2008 to $245,000 in 2009, or three times the annual increment increase of $5,000. The year-to-year average CPI from 2007 to 2008, had increased almost 5.3% to 219.278. See what happened in the year after this large CPI increase below.

No Yearly Decreases to the Limits

In the next year, 2009, the year-to-year average CPI dropped almost 7%. This drop in the average CPI could have actually reduced several of the new 2010 annual limits back to the 2009 levels. However, instead of adjusting or decreasing the annual limits, the IRS decided to keep them the same as the prior year. After 2009, it would take several more years for the annual benefit limits to start increasing again.

Annual Benefit Limit Estimates for 2018

The calculations to be used for the 2018 annual limits are the same as for prior years, but at this point in time, we can only make a good estimate of the increases. Once the July, August and September 2017 CPI numbers are released, more accurate estimates*** can be calculated and used in Column 1 below:

Estimated Annual Limit Calculations for 2018 * **	**(1) Estimated 2017 Jul/Aug/Sep CPI Average**	**(2) Orig. Jul/Aug/Sep Base Year CPI Average**	**(3) Estimated Law-to-Date CPI Increase**	**(4) Orig. Base Year Legal Limit**	**(5) Orig. Base Year Limit x Total Estimated Law-to-Date CPI Increase**	**(6) Estimated 2018 Limits*** **
Calculations	See *** below	Shown above in Col 2	(Est. 1) / (2)	Shown above in Col 4	(4) x (3)	(5) Limited, rounded down
401(a)(17) Compensation Limit[1]	244.955***	177.8	1.378	$200,000	$275,600	$275,000
415(b)(1)(A) Defined Benefit Limit[1]	244.955***	177.8	1.378	$160,000	$220,480	$220,000
415(c)(1)(A) Defined Cont. Limit[2]	244.955***	177.8	1.378	$40,000	$55,120	$55,000
416(i)(1)(A)(i) Key Employee Limit[1]	244.955***	177.8	1.378	$130,000	$179,140	$175,000[4]
402(g)(1) Deferral Limit[3]	244.955***	196.9	1.244	$15,000	$18,660	$18,500
414(v)(s)(B)(i) Catchup Limit[3]	244.955***	196.9	1.244	$5,000	$6,220	$6,000
414(q)(1)(B) HCE Limit[1]	244.955***	157.4	1.556	$80,000	$124,480	$120,000[4]

[1] Limited to $5,000 increment increases (rounded down to nearest $5,000 increment)
[2] Limited to $1,000 increment increases (rounded down to nearest $1,000 increment)
[3] Limited to $500 increment increases (rounded down to nearest $500 increment)
[4] Increased CPI numbers in July, August and/or September 2017 could cause increases to these Annual Limits that are approaching new increment increases.
*** Column (1): As of publication date of this article, the June 2017 CPI, 244.955, was the last number available. When available, this number should be replaced by the July 2017 CPI amount, then the July + Aug 2017 CPI numbers/2, then finally the July + Aug + Sept 2017 CPI numbers/3.

To Summarize the Annual Increase Process

To estimate the 2018 Annual Limits, and beyond, you need to have a good understanding of the processes behind the calculations and confirm that you are using the correct numbers and averages in your calculations. You should be comparing the new average CPI numbers to the original base CPI averages. You will be applying that law-to-date growth in the CPI to the original annual limits to determine the new potential annual limits, then rounding that number down to the correct limit increment increase amounts.

In Conclusion

I hope this has provided you with a greater understanding of the methods behind the annual limit increases. Pay attention to any law changes that could affect these calculations and keep an eye on the growth in inflation. If inflation continues to remain relatively stagnant, then it should be fairly easy to estimate the changes to the annual limits.

If you want to check your calculations feel free to go to my website where I will be showing my most recent estimated annual limit increases on the 401k Information page at www.nqdcsolutions.com/401-k-information.html

About NQDCSolutions

I spent almost 35 years working as a Retirement Consultant on defined contribution and 401(k) plans. My last 20 years included working on all aspects of medium to large sized non-qualified plans, from administration to compliance reviews. My new firm, NQDCSolutions, helps companies stay in compliance with their non-qualified plan document and Code Section 409A. If you need help with any qualified plan or non-qualified plan issues please email me at russmorgan@nqdcsolutions.com, visit me on LinkedIn or check out my website at www.nqdcsolutions.com