

IRS Issues Guidance on Defined Benefit Limits

Recently, the IRS provided further guidance to sponsors of defined benefit plans regarding the calculation of Internal Revenue Code section 415 limits on benefits. The General Agreement on Tariff and Trades (GATT) and the Small Business Job Protection Act (SBJPA) had revised the rules for computing these limits. This IRS guidance specifically addresses areas such as benefit calculations, plan amendments, operational compliance and the effect of these new rules on plan funding.

Benefit Calculations

The new guidance confirms that the "applicable interest rate" used to calculate benefit limits is the same rate used to determine benefit cash-outs. This is the annual interest rate on 30-year Treasury securities. In addition, the mortality tables used in making adjustments to both benefits and benefit limits are the mortality tables established by the Secretary of the Treasury. While the applicable interest rate rules do not apply to governmental plans and nonelecting church plans, the mortality table requirement does apply to these plans.

In this guidance, the IRS provides a three-step procedure to determine limits on benefits that are not distributed as a straight life annuity and are not subject to the cash-out rules. It also gives procedures for calculating limits on benefits that are paid in a single sum. In addition, this guidance describes how to adjust a benefit that is paid before a participant reaches his or her Social Security Retirement Age.

Finally, the IRS describes how the protected benefit rules interact with the new rules on benefit limits. Under the general protected benefit rules, a plan cannot reduce benefits that a participant has already earned. To avoid violating this rule while complying with the GATT and SBJPA rules, the amended plan must reflect the proper interest rate and mortality table. It must also clearly describe how to determine the age-adjusted dollar limit for early retirement distributions.

Transition Rule

Generally, the rules affecting defined benefit plan limits apply to all benefits for plan years beginning after December 31, 1994. However, a plan adopted and in effect before December 8, 1994 may provide that the changes do not apply with respect to benefits accrued before the earlier of:

- The later of the date a plan amendment applying the limitation changes are adopted or made effective; or

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- The first day of the first limitation year beginning after December 31, 1999.

Plan Funding

The revisions to Code section 415 benefit limits also have implications for plan funding. Generally, a plan sponsor must fund the benefits provided under the terms of the plan document. However, if the sponsor does not amend the plan to reflect the new benefit limits, its plan funding, based on the plan document provisions, could exceed the legal limits on benefits. Plan contributions made as a result of such excess benefit calculations are not deductible, and would then be subject to the 10% excise tax on nondeductible contributions. Recognizing this problem, the IRS states that the plan sponsor can anticipate the amendment needed to comply with the Code section 415 limits in determining funding.

Plan Amendment and Operational Compliance

Obviously, it is important for plan sponsors to amend their plans to reflect the changes made to the rules for calculating these benefit limits. The amendment deadline for most plans is the last day of the first plan year beginning on or after January 1, 1999. Governmental plans have an extended remedial amendment period to a later date.

The IRS has recently announced that it will begin accepting GATT and SBJPA determination letter requests for individually-designed plans beginning April 27, 1998. However, sponsors of terminating plans must amend their plans to comply with the 415 limits in connection with the plan termination.

Plans that were amended on or before August 20, 1996, to reflect the original GATT revisions to interest rate and mortality assumptions can now adopt another amendment to repeal that amendment. An employer that adopts a repealing amendment will have the same options for that plan as a plan that was never amended. However, the operation of the plan must conform to the written terms of the plan document. Therefore, distributions made after December 31, 1994, may require recalculation.

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