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Pension ANALYST

Compliance Bulletin

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IRS Publishes Guidance on Accrual Rules in Defined Benefit Plan Conversions

The IRS recently issued Revenue Ruling 2008-7, to provide guidance on the application of the accrual rules when a traditional defined benefit plan converts to a cash balance plan or other hybrid plan formula before 2009, and provides a "greater of" benefit formula. This type of transition formula provides the greater of a participant's benefit as calculated under the original traditional plan formula or his benefit as calculated under the hybrid plan formula. It is designed to prevent an impermissible reduction of participants' accrued benefits.

Background

Qualified defined benefit plans, including hybrid plans, must satisfy one of three accrual rules to ensure that benefits accrue ratably over a participant's working career. The purpose of these rules (the 3% rule, the 133⅓% rule, or the fractional rule) is to prevent backloading, which occurs when a plan's benefit formula provides a faster rate of accrual in the later years of a participant's working career.

In 1999, the IRS suspended the processing of determination letter applications for conversions of traditional defined benefit plans to hybrid plans. However, following the enactment of PPA, the IRS resumed processing determination letters for these "moratorium plans." In doing so, the IRS adopted the position that the "greater of" plan design violates the accrual rules. In response to concerns raised by members of Congress and retirement industry groups, the IRS has now provided guidance regarding the use of "greater of" formulas, as well as limited relief for plans that already use this design.

Revenue Ruling 2008-7

Consistent with existing regulations, the new guidance requires all formulas applicable to a participant to be aggregated when applying the accrual rules. Therefore, even if one formula by itself would produce a benefit that satisfies the 133⅓% rule, and the other formula by itself would produce a benefit that satisfies the fractional rule, the total benefit provided by the interaction of the two formulas must accrue in a manner that satisfies at least one of three accrual rules.

However, if all participants' benefits do not satisfy the same accrual rule, the plan may satisfy one of the accrual rules for some participants and another accrual rule for other participants. In this situation, the classification of participants may not be structured to avoid the accrual rules.

Retroactive Relief

The IRS is now providing limited relief to plans that provide a "greater of" benefit formula to a group of participants, if each formula independently satisfies the accrual rules. This relief applies only if:

- As of February 19, 2008, the plan has a favorable determination letter covering its "greater of" formula; or
- As of February 19, 2008, a remedial amendment period for the plan provisions under which the "greater of" benefit is provided has not expired; or
- The plan is otherwise a moratorium plan.

For plan years beginning before January 1, 2009, the IRS will not disqualify a plan that meets these requirements solely because it provides a "greater of" benefit formula. A plan may be amended retroactively so that each benefit formula separately satisfies the accrual rules.

Future Guidance

The IRS intends to issue proposed regulations that will allow separate testing of backloading with respect to conversions to cash balance plans and other "greater of" formulas. For example, a "greater of" formula can occur in a collectively bargained plan where there is a minimum guaranteed benefit and the employee is entitled to the greater of the plan's regular accruals or the guaranteed minimum benefit. A "greater of" formula can also occur in a plan that contains different benefit formulas due to the acquisition of a company and the merger of one plan and benefit formula into another plan. The proposed regulations will be effective for plan years beginning on or after January 1, 2009.

Next Steps

Plan sponsors should carefully read the information contained in this *Compliance Bulletin.* They should consult with their plan's enrolled actuary or legal counsel if they have any questions about the application of this guidance to their own plans.