Publications

Final IRS Regulations Update Present Value Calculations for Defined Benefit Plans and Expand Anti-Cutback Relief

ATTORNEYS & PROFESSIONALS

Mark Carolan
mcarolan@groom.com
202-861-5424

Louis T. Mazawey
lmazawey@groom.com
202-861-6608

Malcolm Slee
mslee@groom.com
202-861-6337

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Generally, a defined benefit plan provides an accrued benefit commencing at a participant's Normal Retirement Date that pays a flat benefit over the lifetime of the participant. If a plan provides for a distribution as a single lump sum, and also certain other forms as noted below, Internal Revenue Code ("Code") section 417(e) provides that the benefit must satisfy a minimum present value requirement. Typically, the present value calculation reflects an interest discount and a mortality discount, and Code section 417(e) prescribes limitations on the calculation of these discounts.

On January 19, the Internal Revenue Service ("IRS") issued final regulations (T.D. 9987) updating the rules governing the minimum present value requirements for defined benefit plans. 89 Fed. Reg. 3552.

The final regulations:

- Clarify the application of pre-retirement mortality discount factors to calculate minimum present values,
- Permit an alternative approach for how Social Security Level Income Option ("SSLIO") forms of benefit can satisfy the minimum present value rules, and
- Expand the anti-cutback relief, which allows defined benefit plans to amend the lookback months and stability periods that determine the applicable interest rates and mortality tables that are used to calculate benefit distributions and for any other plan purpose.

The regulations generally do not depart from the proposed regulations released on November 25, 2016. Our summary of the final regulations follows.

Pre-Retirement Mortality Discount for Calculating Present Value Prior to Normal Retirement Date

The final regulations clarify that the mortality discount for the pre-retirement period is generally applied to *employer* provided accrued benefits, but is not applied to *employee* provided accrued benefits. The result is that for defined benefit plans that include employee contributions, the minimum present value must generally be calculated by bifurcating the benefit into the employer and employee components, and calculating the present values of each (i.e., employer component reflecting pre-retirement mortality, but employee component not reflecting pre-retirement mortality). Some plans may currently use a different practice, based on a reading of Revenue Ruling 89-60, which suggests that the pre-retirement mortality discount should be applied to both employer and employee components. However, IRS noted that the prior guidance does not reflect the current language of Code section 417(e) (amended in 1994), so the approach under Revenue Ruling 89-60 is superseded, and plans with employee contributions can no longer apply the pre-retirement mortality discount to the whole accrued benefit.

As an alternative to bifurcating the benefit, IRS noted that a plan could choose to disregard the pre-retirement mortality discount for the entire plan benefit. To allow this alternate approach, the final regulations clarify that for plans with employee contributions, disregarding the pre-retirement mortality discount on the entire benefit does not violate the requirement that the qualified joint and survivor annuity be the most valuable optional form of benefit available. Further, the rules specifically permit plans that do not accept employee contributions to disregard pre-retirement mortality if they provide a pre-retirement death benefit equal to the accrued benefit.

We note that it is not common for defined benefit plans to accept employee contributions, and also that most plans that do not allow for employee contributions already apply a mortality discount for the pre-retirement period. Therefore, it is likely that a majority of plans will not need to make any changes to comply with these final rules, which are applicable for annuity starting dates occurring on or after October 1, 2024. However, plan sponsors whose plans are subject to Code section 417(e) should review their calculation methodology to confirm that their current method complies with the updated regulations.

We note that the final regulations do not address how to apply the mortality discount for periods after Normal Retirement Date. IRS noted that this is expected to be addressed in future guidance.

Social Security Level Income Options

The final regulations follow the proposed regulations' position that an SSLIO is subject to the minimum present value rules of Code section 417(e). As background, an SSLIO form of benefit provides a life annuity to a participant, but also includes an additional temporary annuity that is intended to be payable until the participant's assumed future retirement date under Social Security. Taking the SSLIO into account with the Social Security benefit, the total payments are intended to be level for the participant's lifetime. Accordingly, the SSLIO can be viewed as an immediate life annuity, plus a temporary annuity that is intended to equal the estimated Social Security benefit.

Under the proposed regulations, the entire SSLIO would need to have a minimum present value no less than provided under the Code section 417(e) assumptions. Under the final regulations however, a plan can be amended to provide that an SSLIO is implicitly bifurcated into the life annuity and temporary annuity components. To follow this alternative approach, two requirements must be satisfied:

- Normal Retirement Value: The SSLIO's life annuity component must not be less than the participant's total accrued benefit, minus the actuarially equivalent temporary annuity (determined using the applicable interest and mortality rates under Code section 417(e)(3)), both expressed in the normal form of benefit commencing at normal retirement age (or at the current date, if later).
- Current Value: The SSLIO's life annuity component must be no less than the participant's total immediate annuity (i.e. payable under the plan's terms at the current age) minus the amount actuarially equivalent to the temporary annuity (determined using the applicable interest and mortality rates under section 417(e)(3)), both expressed in the form of benefit in which the accrued benefit is expressed but commencing at the current age

Under this approach, the benefit is still subject to certain actuarial equivalence requirements specified in the regulation, but it is possible that an SSLIO benefit that would not have complied with the minimum present value requirement in the proposed regulations, could comply with the actuarial equivalence requirements in the final regulations.

If a plan is amended to provide for this approach, the amendment must satisfy the anti-cutback rules of Code section 411(d)(6). This limits the scope of the new approach, because absent an exception to the anti-cutback rules, it would only be available for newly accrued benefits or total accrued benefits after an applicable wear-away period. Plan sponsors who wish to explore this new approach should carefully review their plan documents with their actuaries to evaluate the practical effect of adding this new feature.

Anti-Cutback Relief for Amending Lookback Months or Stability Periods

The final regulations expressly expand the scope of the rules allowing a defined benefit plan to amend its lookback months or stability periods without violating the anti-cutback rules. Defined benefit plans often use a "lookback month" to reference a specific interest rate, and apply a "stability period" to note how long the plan's interest rate or mortality table will remain the same.

The existing regulations under Code section 417(e) have specific rules for determining which lookback months and stability periods can be used, and also provide a procedure for how the lookback months and stability periods could be changed without violating the anti-cutback rule. Specifically, a plan could change these features if it provided the "greater" benefit calculated under the old approach or the new approach for the following year.

In the past, IRS has informally indicated this anti-cutback relief could apply beyond plan provisions where Code section 417(e) is applicable. The final regulations make it clear that this relief applies for changes to a lookback month or stability period used for any plan purpose. Any stability period or lookback month must still follow the regulations under Code section 417(e), but a plan now can change those features for any purpose without running afoul of the anti-cutback rule, as long as the plan calculates benefits based on the greater of the old approach or the new approach for the one-year transition period.

This new relief is effective for any amendment adopted on or after January 19, 2024.

Next Steps

While we believe it is likely that these complex new rules will not require any changes for most plans, sponsors should review the final regulations with their legal counsel and actuarial consultants to confirm that no changes are necessary. In this regard, the rules are generally effective for annuity starting dates on or after October 1, 2024 so prompt review is advisable.

In cases where the new rules call for plan amendments, they may be delayed until after they are published in the "Required Amendments" list.

If you have questions about these issues, please don't hesitate to reach out to any of the authors or another Groom attorney.