



## **NEW REQUIRED AMENDMENTS FOR CERTAIN PENSION PLANS: NORMAL RETIREMENT AGE TOO LOW?**

Packed in with a large number of other changes, the Pension Protection Act of 2006 contained a little noticed change to the Internal Revenue Code addressing the issue of phased retirement. A new Code section 401(a) (36) was added that permits pension plans (defined benefit and money purchase plans) to make distributions to participants age 62 or older even though they are still employed by the employer sponsoring the plan. This provision marks a departure from prior law which prohibited pension plans from allowing in service distributions prior to the plan's stated Normal Retirement Age ("NRA"). The Normal Retirement Age is the age when accrued periodic benefits are payable in a defined benefit plan and the age when all benefits are fully vested for both defined benefit and money purchase plans.

### **New Retirement Age Regulations:**

The Treasury Department moved swiftly, and on May 22, 2007, issued final regulations addressing the issue of pension plan distributions to ongoing employees. The regulations incorporated the new rule permitting in service distributions to participants age 62 or older. They also pointedly stated that pension benefits can not be paid prior to NRA "solely due to a reduction in the number of hours that an employee works." However, the regulations also redefined requirements for determining a pension plan's NRA. The new regulations now require that the Normal Retirement Age be "an age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed." This language reversed the IRS position held since 1978 that pension plans could be designed with any Normal Retirement Age.

The new regulations not only established a standard for determining the NRA, they also established separate rules and procedures for different classes of NRA, categorized by age brackets. If the NRA is 62 or over, the "typical retirement age" rule does not apply and the age is deemed acceptable. If it is between 55 and 61 it has to meet the "typical retirement age rule," and if the NRA is below age 55, the age is *presumed* to be unacceptable unless the IRS can be convinced that it is reasonable. Public safety employees, the regulation points out, can have an NRA of age 50.

### **Regulation Interpretation Varies:**

Private pension plan practitioners were understandably concerned over the 2007 regulations and a lively dialogue began between Treasury and the private sector concerning pension plans with an NRA between 55 and 61. Based on language contained in a notice issued in the summer of 2007 (Notice 2007-69) as well as informal comments by IRS officials, the private sector was reassured and largely believed that the IRS would extend significant deference to any employer's conclusion that their NRA between 55 and 61 was reasonable. As a result, many practitioners no longer considered the new regulations as requiring any immediate plan changes.

### **Amendments Often Required:**

Any complacency held by practitioners was shaken in mid-June 2009 with a release from the American Society of Pension Professionals & Actuaries ("ASPPA") to the effect that the IRS was requiring concrete data concerning typical retirement ages in each industry. This is true even in plans sponsored by small businesses where such statistics are largely unavailable. Since the penalty for having an NRA under 62 that is not the "typical retirement -



age” is plan disqualification for federal tax purposes, the safe approach is unquestionably to amend the NRA to 62. This is the approach advocated by ASPPA, who has promised to lobby government officials to extend the required amendment due date. In the meantime, pension plans with an NRA under 62 must comply with the new law effective on the first day of the plan year starting after June 30, 2008. The required amendment must be adopted no later than the last day of the Plan Year in which it is effective or (if later) the extended due date for filing the tax return for the fiscal period that includes the amendment effective date.

*It is important to note that profit sharing and 401(k) plans are not affected by these new regulations and need not consider any amendment.*

### **Plan Amendment and Design Considerations:**

Changing a **money purchase plan’s** NRA only changes the age at which a participant becomes fully vested in his or her account and most participants become fully vested by virtue of satisfying the plan’s service requirements for vesting.

The situation is much different, however, for a **defined benefit plan**. In a defined benefit plan, accrued benefits per the formula built into the plan (e.g. 2% of pay per year of employment) *are defined* as being payable at the NRA. If they are payable earlier than the NRA, they are normally reduced and are often increased if payable later than the NRA.

If a defined benefit plan simply increases its NRA, several significant things change: 1). the values of future accrued benefits immediately decrease because the periodic benefit determined by the plan’s formula becomes payable at a later date. This can dramatically reduce the plan’s funding (and tax deduction) amounts. 2). benefits already

accrued must be actuarially adjusted to avoid an impermissible reduction in benefits. 3). participants who were planning on retiring at age 58, for example, must wait until age 62 unless other plan changes are made, 4). For “combo” plans that are sponsored along with defined contribution plans, a changed NRA will probably require a change in the age at which benefits are tested to be sure no discrimination exists in favor of highly paid individuals or owners.

Changing a defined benefit plan’s NRA can be made relatively painless by introducing or modifying the plan’s Early Retirement provision and including a subsidized early retirement benefit. For example, suppose a plan currently has an age 58 NRA and the employer is unable or unwilling to demonstrate that age 58 is a “typical retirement age” for his or her industry. The plan can be amended to change the NRA to 62 and *at the same time* introduce an early retirement benefit payable at age 58 with the provision that there will be *no reduction in benefits* as long as the participant terminates employment at age 58 and starts drawing benefits. Note that employees under age 62 will not be able to receive pension benefits as long as they are working for the plan sponsor, even though they may be age 58 or older. This approach often minimizes the financial impact of the NRA change.

This development will require plan amendments, and plan redesign in some cases, for most pension plans that currently have a Normal Retirement Age under 62. NRS can assist employers and their advisors both in terms of amendment preparation and associated plan redesign.

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