



IRS Provides Relief on Backloading Rules for Cash Balance Plans

The IRS has issued [Revenue Ruling 2008-7](#), which provides guidance and relief on the application of the ERISA anti-backloading rules for plans converted from traditional to cash balance designs using the “greater-of” transition approach. The relief provided in the revenue ruling is good news for many sponsors who were being pushed by IRS agents to make costly and burdensome changes to bring their plans into compliance with an IRS interpretation. The analysis in the ruling on how the anti-backloading rules apply to cash balance conversions and ongoing cash balance benefits is useful but also raises some concerns.

Background

A common approach used by plan sponsors in transitioning from a traditional defined benefit plan to a cash balance plan is to provide some or all employees at conversion with the greater of (1) the benefit under the prior traditional formula (assuming it had continued for a specified period or indefinitely), and (2) the benefit under the new cash balance formula (with opening balances). This is one of the most generous approaches sponsors have used in transitioning to cash balance formulas.

In recent determination reviews following the lifting of the moratorium in ruling on cash balance conversions, the IRS has taken the position that the interaction of the two formulas can cause a violation of the 133-1/3% anti-backloading test. Under the 133-1/3% test, the rate of accrual in a year cannot exceed by more than one-third the rate of accrual in any prior year. A problem can arise if, as the IRS has asserted, the two benefit formulas must be aggregated when tested rather than tested separately. The aggregation approach can cause failures of the 133-1/3% test when there is a crossover between benefit formulas – i.e., the employee’s benefit is higher under one formula until a point in time (the crossover) and then higher under the other formula.

Buck submitted a comment letter to key Treasury and IRS officials, spelling out why the IRS interpretation is unnecessary and can only hurt employees, and urging them to reverse that position. Many other interested parties, including some key members of Congress, offered similar commentary.

Revenue Ruling 2008-7

In Revenue Ruling 2008-7, the IRS concluded that where a cash balance conversion provides the greater of the cash balance benefit and an ongoing prior plan benefit, the law and regulations require that the two ongoing benefit formulas be aggregated when applying the anti-backloading tests. This is the same position the IRS has

taken in recent determination letter reviews. The ruling also discusses how a plan that would not satisfy the 133-1/3% test might be able to satisfy one of the other anti-backloading tests – the fractional rule.

Despite the analysis and conclusions in the ruling, it then goes on to provide what amounts to blanket relief, at least with respect to pre-2009 years, in applying the anti-backloading tests to cash balance conversions using greater-of formulas – whether the prior plan continues for a temporary period or indefinitely. The relief applies if, as of February 19, 2008, the plan had a favorable determination letter on the greater-of formula or if the plan was submitted to the IRS for approval and had been subject to the moratorium.

BUCK COMMENT. *Employers who had been facing threats of plan disqualification over this issue will surely welcome the relief. But, because the relief applies only for tax purposes, it leaves open the question as to whether, in ERISA litigation, courts will be inclined to follow the reasoning in the ruling (i.e., that the law requires the two benefit formulas to be aggregated when applying the anti-backloading tests). The announcement accompanying the ruling indicates that the Treasury and IRS anticipate proposing amendments to regulations, to be effective January 1, 2009, that will allow separate testing of backloading for greater-of formulas. Hopefully, the changes to the regulations will clarify that separate testing is and has been an acceptable approach in greater-of situations, including those involving a cash balance formula or otherwise.*

The revenue ruling confirms that there is not an anti-backloading issue in a pure wear-away conversion – i.e., where the prior plan benefit is frozen and, as required by law, is applied as a minimum against the ongoing cash balance benefit. The ruling points out that such a design can result in zero accruals for a period of time (i.e., a wearaway period) followed by resumption of accruals under the ongoing cash balance formula. While that might appear to violate the 133-1/3% test, the ruling points out the special amendment rule in the statute that requires the cash balance formula be treated as if always in effect, thus permitting the prior formula to be disregarded. This view is consistent with the position taken by IRS agents and by the courts where this issue has been litigated.

The ruling also presents views on how the ERISA anti-backloading rules apply to pure cash balance designs – i.e., for new employees. This is important for cash balance plans that provide benefit credits that increase by age or service. Although IRS officials have over the years taken positions on how the anti-backloading rules apply to cash balance designs, this is the first formal guidance in this area.

BUCK COMMENT. *The revenue ruling takes the position that the 133-1/3% test is an operational test that must be run annually. That approach is contrary to a common understanding that the 133-1/3% test is a design, not operational, based test. The prospect that a cash balance plan might become impermissibly backloaded just because of a dip in interest crediting rates under a plan specified variable basis is troubling.*

Given that this guidance will affect hundreds or thousands of plans, we think it should be addressed in proposed regulations that are open to public comments. Hopefully, the amendments to the regulations that the IRS intends to issue in the near future will cover these issues as well.

The revenue ruling indicates that the fractional rule is available to a cash balance plan, however, the manner in which the fractional rule could be used is not entirely clear. Some courts have taken a contrary position (i.e., that the fractional rule is not available to cash balance plans) – hopefully this ruling will influence future court positions. It will be helpful if the forthcoming proposed regulations deal with this issue.

Conclusion

Revenue Ruling 2008-7 provides welcome relief to the many plan sponsors that provide greater-of transition provisions. Hopefully, forthcoming regulations will provide more flexibility and clarity on how to apply the anti-backloading rules to cash balance plans. Buck's consultants stand ready to assist you in reviewing how this ruling affects your existing or prospective plan design.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.