

RE: Implications of Normal Retirement Age Regulations for Governmental Plans¹
FROM: Paul Zorn
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On May 22, 2007, the IRS issued final regulations related to the definition of normal retirement age (TD 9325). The new regulations were developed to provide guidance related to the addition of Internal Revenue Code (Code) § 401(a)(36) by the 2006 Pension Protection Act, allowing in-service distributions from pension plans beginning at age 62.

Among other changes, the final regulations amend Treas. Reg. § 1.401(a)-1 to allow in-service distributions beginning at age 62. However, in so doing, they define normal retirement age as being “not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry...” In addition, the regulations provide several safe harbors that the IRS will presume to be the “typical” earliest normal retirement ages:

- Age 55 for non-public safety employees,
- Age 50 for public safety employees.

Retirement ages below age 55 (or age 50 for public safety) are presumed not to be typical and so in-service distributions before these ages would not be allowed. However, the regulations do allow the IRS Commissioner to determine whether earlier retirement ages may be considered typical based on relevant facts and circumstances.

The new regulations are generally effective as of May 22, 2007. In the case of governmental plans, they are effective for plan years beginning on or after January 1, 2009. Plans that fail to satisfy these rules may be disqualified.

Notice 2007-69

The new regulations raised concerns regarding their meaning and the time needed to comply. In response, the IRS issued Notice 2007-69, providing temporary relief for private-sector plans until the first day of the plan year beginning after June 30, 2008. (The temporary relief does not apply to governmental plans because of their extended effective date.) Under the Notice, the IRS will not disqualify a plan with a normal retirement age earlier than age 62 (but not earlier than age 55) solely because it does not meet the new regulations, provided:

- The plan, immediately prior to May 22, 2007, provided a definition of normal retirement age that was earlier than age 62;
- No possible plan participant hired at age 18 or older could attain the plan’s normal retirement age before age 40;
- The plan sponsor adopts a good faith interim amendment effective no later than the first day of the plan year beginning after June 30, 2008, and the plan is operated in accordance with the amendment as of the amendment’s effective date; and

¹ This memorandum describes changes to certain tax rules applicable to retirement plans. The author is not an attorney and the statements made are not intended as legal advice or opinion. Plan administrators should seek the advice of qualified legal counsel to ensure that plan provisions and documents comply with applicable federal laws and regulations.

- The plan sponsor adopts the interim amendment in a timely manner based on the employer's plan year and tax year.

In addition, Notice 2007-69 also provides a temporary presumption of reasonableness for plans with a normal retirement age earlier than age 55, provided:

- The plan, immediately prior to May 22, 2007, provided a definition of normal retirement age that was earlier than age 55;
- No possible plan participant hired at age 18 or older could attain the plan's normal retirement age before age 40;
- The plan sponsor submits a letter ruling request to the IRS by June 30, 2008, on whether its definition of normal retirement age satisfies the final regulations.

Normal Retirement Age Based on Service

Notice 2007-69 also states that the new regulations do not provide a safe harbor or other guidance with respect to a normal retirement age that is based on years of service. Moreover, Treasury and the IRS expect that a plan under which the normal retirement age changes to an earlier date based on years of service would not satisfy the vesting rules of Code § 411 (from which governmental plans are exempt).

However, Notice 2007-69 goes on to say that the new regulations do not mean a plan cannot provide benefits based on the completion of years of service. As stated in the Notice, "an early retirement benefit, including an unreduced early retirement benefit, is permitted to be conditioned on completion of a stated number of years of service." However, the early retirement benefit may only begin to be paid after separation from service.

Implications for Governmental Plans

The implications of the new regulations for governmental plans are unclear and potentially problematic. Since they are located within the regulations related to Code § 401(a), they are applicable to governmental plans. However, as stated in the regulations' preamble, the rules were added in the context of allowing pension plans to make in-service distributions for participants who have reached normal retirement age. Consequently, while they clearly apply to in-service distributions, their application (if any) outside of that context is less clear.

In addition, Notice 2007-69 points out that the regulations would not prevent plans from providing an unreduced benefit paid at a date that is earlier than the normal retirement age or that is based on years of service. However, such distributions would only be permitted after severance of employment. These clarifications are especially relevant for governmental plans, since they often allow unreduced benefits to be paid based on several combinations of age and service (for example, age 50 with 30 years of service or age 55 with 25 years).

As a result of these age/service combinations for unreduced retirement, fewer governmental plans allow in-service distributions, particularly at these earlier ages. It appears that the governmental plans most affected by the new regulations will be those that offer in-service distributions now or in the future. If they do not define normal retirement age in accordance with the regulations, they will have to amend their plan accordingly to provide the in-service distributions. However, in defining normal retirement age, they may be able to restrict the definition to the purpose of in-service distributions, rather than applying it broadly for benefit accruals or other purposes. This is something that should be discussed with legal counsel.

It is unclear how the IRS will apply these rules to governmental plans beyond the context of in-service distributions, if at all. If the rules were applied generally to governmental plans, it would likely raise significant concerns. For plans that currently allow unreduced retirement benefits to be paid before age 55 (or 50 for public safety employees), increasing the retirement age could result in a breach of contract under state and federal constitutions. On the other hand, for plans that allow unreduced retirement only after 62, the new regulations could lower the retirement age, thereby increasing plan costs.

In Notice 2007-69, the IRS requested comments on whether normal retirement age under governmental plans may be based on years of service, and whether and how such a plan would satisfy the pre-ERISA vesting rules. It is likely the IRS will issue further guidance in 2008 about the application of these regulations to governmental plans.

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