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IRS Final Regulations Allow Pension Plan Sponsors in Bankruptcy to Eliminate Prohibited Payment Options

Under Section 436 of the Internal Revenue Code, a single employer defined benefit plan sponsored by a company in bankruptcy cannot pay any "prohibited payments" (e.g., lump sums, Social Security level income annuity payments) if the plan is less than 100% funded. In June 2012, the IRS issued proposed regulations permitting such a defined benefit plan to be amended to eliminate prohibited payment forms without violating the anti-cutback requirements of Internal Revenue Code Section 411(d)(6) if certain conditions are satisfied. On November 7, 2012, the IRS finalized the proposed regulations.

Section 411(d)(6) provides that a defined benefit plan cannot be amended to reduce or eliminate benefits previously accrued by plan participants. A participant's "accrued benefit" generally includes a right to all optional forms of payment available at the time the benefit was earned. Section 411(d)(6) contains rules under which a plan may be amended to eliminate certain optional forms of payment, but generally requires that the plan retain an existing lump sum and/or level income option. The new final regulations, however, permit a plan amendment that permanently eliminates any prohibited payment form. (By contrast, Section 436 does not contemplate permanent elimination of prohibited payment forms. Under Section 436, prohibited payments are merely suspended while the plan sponsor is in bankruptcy, and those options again become available upon emergence, subject to minimum funding thresholds.)

Under the final regulations, a single employer defined benefit plan may be amended to permanently eliminate prohibited payment forms if:

- The plan's enrolled actuary certifies that the plan is less than 100% funded for the plan year during which the amendment is adopted;
- The plan cannot make prohibited payments because the plan sponsor is in bankruptcy under Title 11 of the U.S. Code or a similar federal or state law;
- The bankruptcy court issues an order, after notice to affected parties (including plan participants, beneficiaries, applicable unions and the Pension Benefit Guaranty Corporation (PBGC)) and a hearing, that eliminating the optional form of payment is necessary to avoid a distress or involuntary termination of the plan before the plan sponsor emerges from bankruptcy; and
- The PBGC issues a determination that eliminating the optional form of payment is necessary in order to avoid a distress or involuntary termination of the plan before the plan sponsor emerges from bankruptcy, and the plan's funding is not sufficient to pay benefits guaranteed by the PBGC.

The final regulations are effective as of November 8, 2012.

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