SUMMIT
Benefit & Actuarial Services, Inc.

Defined Benefit Plans: What Level of Employer Commitment is required?

When considering the adoption of a defined benefit plan for a business, there are two very important considerations:

1. **The employer's financial commitment to the plan; and**
2. **The permanency requirement.**

These two important considerations are discussed below.

<u>Employer Commitment</u>

Unlike a profit sharing plan, company contributions are required each year, with the exception being when plan assets exceed liabilities. At the time a defined benefit plan is established, the actuary will work with the company to determine the level of commitment that it wishes to make. This may be in the form of a percentage of payroll (e.g., 5% of payroll) or a dollar amount ($150,000 per year).

After the plan has been established, the company may find itself in a difficult position, due to economic or financial factors. There is a mistaken belief that once a DB plan is established, the contribution cannot be reduced. This is not correct. It is possible to amend the plan to reduce or eliminate a required contribution, but this must occur early in a plan year before plan participants have earned benefits under the plan; generally before any participant works 1,000 hours This generally gives the plan sponsor about a period of four months into the plan year to make the decision to amend the benefits and contribution level for that plan year. If the financial or economic difficulty occurs late in the plan year, then it may simply be too late to reduce or eliminate the required contribution. The plan sponsor will have some alternatives to manage this:

1. **Wait until the latest possible time to make the contribution: 9½ months following the close of the plan year;**
2. **Borrow the funds needed to satisfy the minimum contribution requirement;**
3. **Sustain a funding deficiency (incur a 10% excise tax) and contribute the deficiency as soon as possible in the following plan year**

We often get asked how often a DB plan can be amended. There are no hard rules on this, but we do not recommend frequent amendments as this could expose the plan to a challenge from the IRS.

Summary: Once established a DB plan can be amended in future years to reduce the funding level, but these amendments must be done early in a plan year, and must be infrequent.

SUMMIT
Benefit & Actuarial Services, Inc.

Permanency Requirement

Although the Internal Revenue Code itself does not expressly state that a plan must be permanent to be qualified under Code Section 401(a), the applicable Treasury regulations state that the term "plan" implies a permanent, as distinct from a temporary, program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions under the plan, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general.

The length of time that a plan must exist to satisfy the permanency requirement is not specified in the Internal Revenue Code or regulations. In our experience, the minimum period of time is five years. If the plan sponsor does not intend to keep the defined benefit plan for at least five years, it should generally not be established. However this does not mean that the plan must be maintained at its initial contribution level fort five years! As discussed above, it can be amended to reduce contributions at any time.

In a 2008 internal memorandum written by the IRS Director of Employee Plans regarding certain employee plan design issues, the Director acknowledges that the ability to sponsor a plan is a function of the financial cycles of a business. Although a company may believe in one year that it is profitable and will be in the future, circumstances may change. Therefore, the memo notes that the IRS has not been unduly aggressive in pursuing the issue of permanence. This notation in the memo is an indication that the IRS's lack of harsh enforcement of this issue has been purposeful, and helps put the issue of permanency in proper perspective. [Memorandum to Director of Employee Plans Rulings and Agreements and Director of Enforcement, dated October 1, 2008]