

## IRS Publishes Final Anti-Cutback Rules

**WHO'S AFFECTED** These rules apply to qualified defined benefit and defined contribution plans that are subject to ERISA. Governmental plans and plans sponsored by churches that do not elect to be covered by ERISA (“non-electing church plans”) are not subject to these rules. However, these rules do apply to employer contributions made to 403(b) plans that are covered by ERISA.

**BACKGROUND AND SUMMARY** On August 12, 2005, the IRS issued final rules providing guidance for defined benefit plans on the anti-cutback provisions of ERISA and the Internal Revenue Code. Earlier this year, on January 25, 2005, the IRS issued revised rules for defined contribution plans on the elimination of optional forms of benefit. This *Pension Analyst* is intended to discuss both pieces of guidance.

These rules finally give defined benefit plan sponsors the ability to remove outdated or unused forms of payment from their plans. However, they do not make it easy to do so. To their credit, the rules do give these plan sponsors the ability to remove retroactive annuity starting date provisions that turned out to be more burdensome to administer than was anticipated when they were added to the plans.

**ACTION AND NEXT STEPS** In general, the final rules for defined contribution plans apply to plan amendments adopted and effective on or after January 25, 2005. The final defined benefit plan rules generally apply to plan amendments adopted and effective on or after August 12, 2005. Plan sponsors should review their plan documents to determine how the new rules impact plan provisions. If Prudential Retirement provides document services for your plan and you would like to amend your plan, please contact your Prudential representative for assistance. Sponsors of defined benefit plans should not make design changes to those plans without first consulting the plan’s enrolled actuary.

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In general, a plan sponsor may not amend a qualified plan to decrease any participant's accrued benefit. This is known as the "anti-cutback" rule. The anti-cutback rule also prohibits plan amendments that eliminate or reduce "protected benefits."

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) directed the IRS to issue regulations to permit plans to reduce or eliminate benefits, subsidies and optional forms of payment that create substantial burdens or complexities for a plan. In response, the IRS published updated rules for the elimination of benefits under defined contribution plans on January 25, 2005 (the existing rules regarding the elimination of benefits under defined contribution plans had been issued on September 6, 2000). The IRS published final rules for defined benefit plans on August 12, 2005.

## Definitions

The ERISA and Internal Revenue Code vesting rules already define the term "accrued benefit." In a defined benefit plan, a participant's accrued benefit is the benefit payable at a specified time, as determined under the plan's benefit formula. In a defined contribution plan, a participant's accrued benefit is the current value of his account balance.

The new anti-cutback rules contain revised definitions of the term "optional forms of benefit," "protected benefits," and "ancillary benefits."

In general, an "optional form of benefit" is a form of payment that is available with respect to a participant's accrued benefit.

A "protected benefit" is the portion of:

- An optional form of benefit;
- An early retirement benefit; or
- A retirement-type subsidy,

that is attributable to benefits accrued before the applicable amendment date.

"Ancillary benefits" include:

- Social Security supplements other than Qualified Social Security Supplements;
- Disability benefits not in excess of qualified disability benefits;
- Life insurance benefits;
- Section 401(h) medical benefits;
- Death benefits other than death benefits that are part of an optional form of benefit; and
- Plant shutdown benefits that do not continue past retirement age and do not affect the payment of an accrued benefit.

The anti-cutback rules *do not apply* to "ancillary benefits." As a result, ancillary benefits may be removed at any time. *For example, the survivor portion of a joint and survivor benefit is a protected benefit, because it is part of an optional form of benefit. However, a \$5,000 death benefit that is payable to all participants except those who have received single-sum distributions is an ancillary benefit because it is not part of a specific optional form of benefit.*

## Updated Defined Contribution Plan Rules

Under the revised rules, the payment of a participant's defined contribution plan account balance upon his death is no longer considered an ancillary benefit. Instead, a defined contribution plan death benefit is now considered a protected benefit, which cannot be eliminated.

However, effective January 25, 2005, sponsors of qualified defined contribution plans may amend their plans to remove optional forms of benefit without having to make the eliminated forms of payment available for an additional 90 days.

Under the revised rules, an amendment removing an optional form of payment from a defined contribution plan must:

- Only apply to payments with annuity starting dates occurring after the date the amendment is adopted; and
- Provide that the remaining optional forms of payment available include a single sum payment form that is "otherwise identical" to the form of payment being eliminated.

A single sum payment is "otherwise identical" to an eliminated form of payment only if it:

- Is available for payment on the date on which the eliminated form would have been available for payment;
- Is available for payment in the same medium (e.g., cash, in-kind) as the eliminated form of payment; and
- Does not impose any eligibility conditions that did not apply to the eliminated form of payment.

*For example, Plan X is a profit sharing plan, with a calendar plan year, which permits distributions to be made in a single sum or in various annuity forms. Annuity payments begin as of the first day of the month following a participant's termination date. Plan X is not subject to the qualified joint and survivor annuity rules. On September 10, 2005, Plan X is amended to remove the annuity payment options, effective for distributions beginning on or after October 1, 2005. After October 1, single sum payments will continue to be available and payable as of the first day of the month following a participant's termination date.*

This rule applies to all qualified defined contributions plans but it does not override the qualified joint and survivor (QJSA) rules that apply to money purchase pension plans and certain profit-sharing plans. As a result, a money purchase pension plan cannot be amended to remove all annuity forms of payment, because it must offer the QJSA form. However, it could be amended to remove non-QJSA annuity forms of payment under these rules.

## General Anti-Cutback Rules

The final anti-cutback rules apply to participants' entire accrued benefits under a plan as of the "applicable amendment date." The "applicable amendment date" is the later of the amendment effective date or adoption date.

All amendments with the same applicable amendment date are treated as one amendment. If there are two amendments with the same applicable amendment date and one amendment increases participants' accrued benefits while the other amendment decreases participants' accrued benefits, the plan will only violate the anti-cutback rules if the net effect of the two amendments is to decrease any participant's accrued benefit.

The final rules also include a "multiple amendment" rule. Under this rule, a plan violates the anti-cutback rules if a series of plan amendments, when taken together, has the effect of reducing or eliminating an accrued benefit. Plan amendments adopted within a three-year period are taken into account for purposes of this rule.

## Elimination of Defined Benefit Plan Optional Forms of Payment

The final rules now permit defined benefit plans to completely eliminate:

- Redundant optional forms of benefit; or
- Non-core optional forms of benefit.

### Redundant Optional Forms

An optional form of benefit is "redundant" and may be eliminated if:

- A retained optional form of benefit is in the same "family" of optional forms of benefit as the form that is being eliminated; and
- A participant's rights with respect to a retained optional form of benefit are not subject to materially greater restrictions (e.g., conditions relating to eligibility or restrictions on the participant's right to receive an in-kind distribution) than the form that is being eliminated.

For these purposes, there are six families of optional forms. Not every optional form of benefit fits within one of the six families. For example, a single-sum payment option does not fit into any of these families. As a result, a single-sum form of payment can be eliminated only with respect to benefits that have not yet accrued.

Among other requirements, there must be a waiting period between the date the plan sponsor adopts an amendment eliminating a redundant optional form and the amendment effective date. This waiting period is the notice period required for QJSA explanations (currently 90 days). *For example, if a plan sponsor adopts this type of amendment on October 1, 2005, the redundant form of benefit must continue to be available until December 31, 2005.*

While these rules do not make it easy to remove redundant forms of benefit, they do provide welcome relief for plan sponsors that offered retroactive annuity starting dates under the broad EGTRRA rules, but no longer wanted to do so once the IRS issued the related regulations. Subject to the waiting period and other rules, a plan sponsor now may replace a benefit with a retroactive annuity starting date with a benefit that is payable without a retroactive annuity starting date. *For example, a plan may eliminate a 10-year certain and life annuity payable with a retroactive annuity starting date, as long as a 10-year certain and life annuity payable with a current annuity starting date remains available.*

### **Non-Core Optional Forms**

A non-core optional form of benefit may be eliminated if the plan, after amendment, offers “core options.” The final rules define “core options” as:

- A straight life annuity;
- A joint and 75% survivor annuity;
- A 10-year certain and life annuity; and
- The most valuable option for a participant with a short life expectancy.

A plan that offers both the 50% and 100% joint and survivor annuity options may treat these options as core options rather than offering a joint and 75% survivor annuity.

These rules also provide guidelines for determining the most valuable option for a participant with a short life expectancy. In most cases, a plan that has a single-sum payment option may treat that form of benefit as the most valuable option. If the plan does not have a single-sum payment option, it may treat a joint and survivor annuity option as the most valuable option if the continuation percentage is at least 75% and is at least as great as the highest continuation percentage available before the amendment. Finally, a plan may treat a term certain and life annuity with a term certain of at least 15 years as the most valuable option.

Optional forms of benefit that are eliminated under the core options rule must continue to be offered for annuity commencement dates occurring up to four years after the date the amendment is adopted. *For example, if a plan amendment is adopted on October 1, 2005, to remove the joint and 66 $\frac{2}{3}$  survivor annuity option, while retaining the 50% and 100% joint and survivor options, the joint and 66 $\frac{2}{3}$  survivor option must remain available for annuity commencement dates occurring prior to October 1, 2009.*

If an optional form of benefit is being eliminated and includes either a social security leveling feature or a refund of employee contributions feature, at least one of the remaining core options must offer this feature. A plan cannot use this core option amendment method to eliminate a single-sum payment option unless that option is available to less than 25% of a participant’s accrued benefit.

## **Elimination of Early Retirement Benefits and Retirement-Type Subsidies**

The final rules permit defined benefit plan sponsors to eliminate or reduce early retirement benefits and retirement-type subsidies if those features create significant burdens or complexities for the plan and its participants. However, the elimination may not adversely affect the rights of any participant in more than a de minimis manner. Whether the optional form creates significant burdens and complexities is a facts and circumstances determination. The rules list various relevant factors.

## **Elimination of Contingent Event Benefits**

The final rules define a contingent-event benefit in a defined benefit plan as a benefit that is contingent on the occurrence of certain events, such as a plant shutdown or involuntary separation, and that continues after retirement. If a contingent-event benefit is a retirement-type subsidy, then a plan amendment adopted after December 31, 2005, cannot reduce or eliminate that benefit with respect to service before the applicable amendment date. This rule applies whether the contingent event that triggers the payment of the benefit occurs before or after the amendment adoption date.

## **Participant Notice Requirements**

Plan administrators must give participants and beneficiaries advance notice (“Section 204(h) notices”) of plan amendments that significantly reduce the rate of future accruals or eliminate or significantly reduce an early retirement benefit or retirement-type subsidy. The final rules clarify that the elimination of an optional form of benefit as permitted under the anti-cutback rules does not require the distribution of Section 204(h) notices. However, the reduction of an early retirement benefit or a retirement-type subsidy with respect to service before the amendment date might require advance notice.

## **Next Steps**

Plan sponsors should review their plan documents to determine how the new rules impact plan provisions. If Prudential Retirement provides document services for your plan and you would like to amend your plan, please contact your Prudential representative for assistance.

## **IRS Proposes Additional Anti-Cutback Rules**

The IRS has also issued proposed rules, which provide guidance on when a plan may alter a benefit entitlement and add a condition with respect to benefits accrued before the date of the amendment. These rules reflect the Supreme Court’s decision in *Central Laborers’ Pension Fund v. Heinz*.

In June 2004, the Supreme Court ruled that ERISA prohibits a plan amendment that expands the categories of post-retirement employment that result in the suspension of payment of early retirement benefits already accrued. The case involved two inactive participants in a multiemployer pension plan who were receiving early retirement benefits. A plan amendment adopted after their benefit payments had begun expanded the definition of “disqualifying employment” to cover work as a construction supervisor. Since both participants were working as

construction supervisors at the time of the amendment, the plan suspended their benefit payments. The Court ruled that such a condition may not be imposed after a benefit has already accrued, and the right to receive benefit payments cannot be limited by a new condition narrowing that right.

In May 2005, the IRS issued guidance that limited the retroactive application of this ruling with respect to plan amendments adopted before June 7, 2004.

The proposed rules, which would be effective as of June 7, 2004, provide that a plan amendment that decreases accrued benefits, or that otherwise places greater restriction on the rights to protected benefits violates the anti-cutback rules, even if the amendment merely adds a condition that is otherwise permitted under the vesting rules. However, this type of plan amendment may add a restriction or condition on benefits that accrue after the amendment date.

**Pension Analyst by Prudential Retirement**

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