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Pension ANALYST

Important Information Plan Design December 2006

IRS Publishes Additional Anti-Cutback Guidance

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 regulations on the elimination of optional forms of benefit. However, these regulations reserved two topics for later guidance - a utilization test and the interaction of the permitted forfeiture rules under the Internal Revenue Code with the anti-cutback rules taking into consideration the Supreme Court’s decision in *Central Laborers’ Pension Fund v. Heinz.* On August 9, 2006, the IRS issued final rules on these two remaining topics.

These rules describe the utilization test, which plan sponsors may use to remove outdated or unused forms of payment from their plans, provided they satisfy certain requirements. The utilization test applies to defined benefit plans. It also applies to defined contribution plans that are subject to the qualified joint and survivor annuity requirements (e.g., money purchase pension plans). The IRS previously issued rules that make it easier for other defined contribution plans such as 401(k) plans and profit sharing plans to remove optional forms of payment. The new final rules also provide that a plan amendment that places greater restrictions or conditions on a participant’s right to a protected benefit by adding or modifying a plan provision relating to the suspension of benefits payments violates the anti-cutback rules.

Finally, these rules clarify the interaction of the vesting requirements with the anti-cutback rules. The rules provide that a plan amendment that decreases a participant’s accrued benefit or imposes greater restrictions or conditions on a participant’s protected benefit violates the anti-cutback rules, even if the amendment is permitted under the vesting rules.

ACTION AND NEXT STEPS Plan sponsors should read the guidance contained in this publication to determine how the new rules impact their plan provisions and administration, especially if they have any plan mergers in process. 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." A "protected benefit" is the portion of:

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

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

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) directed the IRS to issue regulations to permit plans to eliminate or reduce benefits, subsidies and optional forms of payment that create substantial burdens or complexities for a plan. In response, the IRS published final rules in 2005 addressing the elimination of benefits under both defined contribution plans and defined benefit plans. At the same time, the IRS issued proposed rules to reflect the Supreme Court's decision in *Central Laborers' Pension Fund v. Heinz* and to introduce the utilization test, which allows plan sponsors to eliminate rarely used forms of payment. The IRS has now published final rules with respect to these outstanding issues.

Central Laborers' Pension Fund v. Heinz

In June 2004, the Supreme Court ruled in *Central Laborers' Pension Fund v. Heinz* 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 benefits 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 2005, the IRS issued guidance that limited the retroactive application of this ruling to plan amendments adopted on or after June 7, 2004. The final rules now provide that a plan amendment that places greater restrictions or conditions on a participant's right to a protected benefit by adding or modifying a plan provision relating to the suspension of benefit payments violates the anti-cutback rule.

Sponsors of multiemployer plans that have been amended to expand the definition of "disqualifying employment" in a manner that now is unacceptable must adopt a reforming amendment by January 1, 2007, to restore the suspended pensions. In the interim, as provided in IRS Revenue Procedures 2005-23 and 2005-76, plans must operationally comply with any such reforming amendment and provide affected participants with a notice of their right to retroactively elect to start receiving benefit payments.

Changes to Plan Vesting Provisions

Historically, plan sponsors have not been particularly concerned about the application of the anti-cutback rule to changes made to plan vesting provisions. In the case of vesting schedule changes, the two main concerns have been protecting the prior vesting percentages and providing participants who had at least three years of service with the opportunity to remain under the old vesting schedule. However, as a result of the *Heinz* decision, plan sponsors must be more aware of the interaction of the vesting rules with the anti-cutback rule. The new final rules make it clear that a plan amendment may not place greater restrictions or conditions on a participant's rights to protected benefits, even if the amendment merely adds a restriction or condition that is otherwise allowed under the vesting rules.

One example of this new application of the anti-cutback rule involves *the addition of the "rule of parity"* to a plan. Under the rule of parity, a rehired participant's prior vesting service is disregarded if he is 0% vested and incurs a five-year break-in-service. This is a fairly common provision in defined benefit plans and may also be included in defined contribution plans. Under the final rules, a plan sponsor may amend a plan to include the rule of parity, but this rule may only be applied to benefits accrued after the later of the amendment adoption date or amendment effective date.

Another example of the new application of the anti-cutback rule is when there is *a change in a plan's vesting schedule*. This situation commonly occurs when plans are being merged. Plan sponsors must now be careful to comply with three separate rules when making vesting schedule changes:

- A participant's vesting percentage cannot be reduced;
- A participant with at least three years of service must be allowed to elect to remain under the old vesting schedule; and
- A new, less generous vesting schedule cannot be applied to benefits that have already accrued, regardless of whether a participant has the right to elect to remain under the old vesting schedule.

To satisfy the third requirement, plan sponsors that amend plan vesting schedules may want to consider:

- Applying the old vesting schedule to all benefits (past and future) accrued by existing plan participants, and the new schedule only to new participants; or
- Applying a "melded" vesting schedule that applies the greater vesting percentage under the two schedules to each participant. This approach is typically used in plan merger situations and was commonly used by plan sponsors that had to change vesting schedules as a result of EGTRRA.

For example: Employer Y sponsors Plan D, a profit-sharing plan. Plan D contains a seven-year graded vesting schedule. Employer Y acquires another company, which sponsors Plan E, another profit-sharing plan. Plan E contains a five-year cliff vesting schedule. In 2006, Plan E is merged into Plan D. The vesting schedule requirements may be satisfied in either of the following ways:

- *All original Plan D participants and future participants are subject to the graded vesting schedule (which will have to be accelerated in 2007 to comply with the Pension Protection Act of 2006 (PPA)). All former Plan E participants remain subject to the cliff vesting schedule. Since there is no change to the Plan E participants' vesting schedule, there is no need to provide vesting schedule elections and there is no anti-cutback issue. However, this approach may result in additional administrative complexities and costs, to ensure that the correct schedules are applied to the correct participants.*
- *All plan participants are subject to a melded vesting schedule that provides 20% vesting after three years of service, 40% vesting after 4 years of service, and 100% vesting after 5 years of service. Since the new schedule is, at all levels, at least as good as either of the old schedules, Plan D does not need to offer any participant elections. In addition, previously-accrued benefits*

are not subject to more restrictive vesting provisions. The drawback to this approach is that participants become 100% vested earlier than they would have under the original graded vesting schedule, reducing the amount of forfeitures available for use as an employer credit. Of course, the melded schedule will have to be revised again in 2007, to comply with PPA.

The final rules do provide one exception to the anti-cutback rules with respect to vesting provision changes. A plan sponsor may amend a plan that counts hours or uses an equivalencies method for crediting vesting service to *change the vesting computation period*, without worrying about the anti-cutback rule, as long as the amendment satisfies the Department of Labor's rules for making such a change.

Utilization Test

In its 2005 final regulations, the IRS allowed defined benefit plan sponsors to eliminate redundant optional forms of benefit or non-core optional forms of benefit. Under these new regulations, the IRS adds a "utilization test" that permits the elimination of an optional form of benefit if the following requirements are satisfied:

- The form of benefit being eliminated is not a "core option";
- The plan amendment eliminating the optional form does not apply to annuity starting dates occurring within the 90-day period following the date the amendment is adopted (effective for plan years beginning after December 31, 2006, PPA extends this 90-day period to 180 days);
- The form of benefit being eliminated has been available to at least the "applicable number" of participants who are taken into account during the "look-back period" (generally, 50 participants); and
- No participant has elected the optional form of benefit during the look-back period.

Core Options

Under the utilization test, a plan cannot eliminate any core option. Core options include:

- 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.

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 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.

Look-Back Period

The look-back period for the utilization test includes that portion of the plan year in which the plan amendment is adopted that precedes the date of adoption (the "pre-adoption period") and the two plan years immediately preceding the pre-adoption period. At least one of these plan years must be a 12-month plan year. A plan may exclude from the look-back period the calendar month in which the amendment is adopted and the preceding one or two calendar months to the extent those preceding months are within the pre-adoption period.

Eligible Participants

A participant is taken into account for purposes of the utilization test only if he was eligible to elect the form of benefit being eliminated within the look-back period. However, this group excludes participants who:

- Did not elect any optional form of benefit with an annuity starting date within the look-back period;
- Elected single-sum distributions that were at least 25% of their accrued benefits;
- Elected an optional form of benefit that was only available during a limited period of time and that contained a retirement-type subsidy that was not available under any other form of benefit with the same annuity starting date; or
- Elected an optional form of benefit with an annuity starting date more than ten years before normal retirement age.

In general, at least 50 participants must be included in the eligible group for the look-back period. However, if the plan has fewer than 50 eligible participants during the look-back period, the plan sponsor may extend the look-back period to include the three, four, or five plan years immediately preceding the plan year in which the amendment is adopted. If a plan does not satisfy the 50 participant requirement with a five-year look-back period, it will not be able to use the utilization test to eliminate an optional form of benefit. For the most part, only larger plans will be able to use this approach to eliminate optional forms of benefit.

Bifurcated Benefits

Some plans allow participants to make different payment elections with respect to two or more separate portions of the participant's benefit. For example, as the result of a merger, a participant may have different distribution options for the portion of his benefit earned before the date of the merger and the portion earned after the merger. Another example is a situation where a participant accrues a benefit under a traditional defined benefit pension plan, which is typically paid as an annuity, and accrues a separate benefit after the plan, is converted to a cash balance plan, which typically offers a single sum payment as an optional form of payment. The final anti-cutback rules apply separately to each portion of the total benefit that is subject to a separate election. Technically, the redundancy rule is available to both defined benefit and defined contribution plans, but it has more practical impact on defined benefit plans, since defined contribution plans have more leeway in removing optional forms.

Effective Dates

In general, issues involving the suspension of benefits rules are effective on or after June 7, 2004, the date of the *Heinz* decision. The vesting provisions and the bifurcated benefits rules are effective for plan amendments adopted after August 9, 2006. The utilization test requirements are applicable for plan amendments adopted after December 31, 2006.

Next Steps

Plan sponsors should review their plan documents to determine how this most recent guidance impacts plan provisions. Plan sponsors that acquire plans as the result of a corporate transaction (e.g., merger or acquisition) should pay careful attention to the amendment of vesting schedules, which may impact a participant's vested benefit.

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