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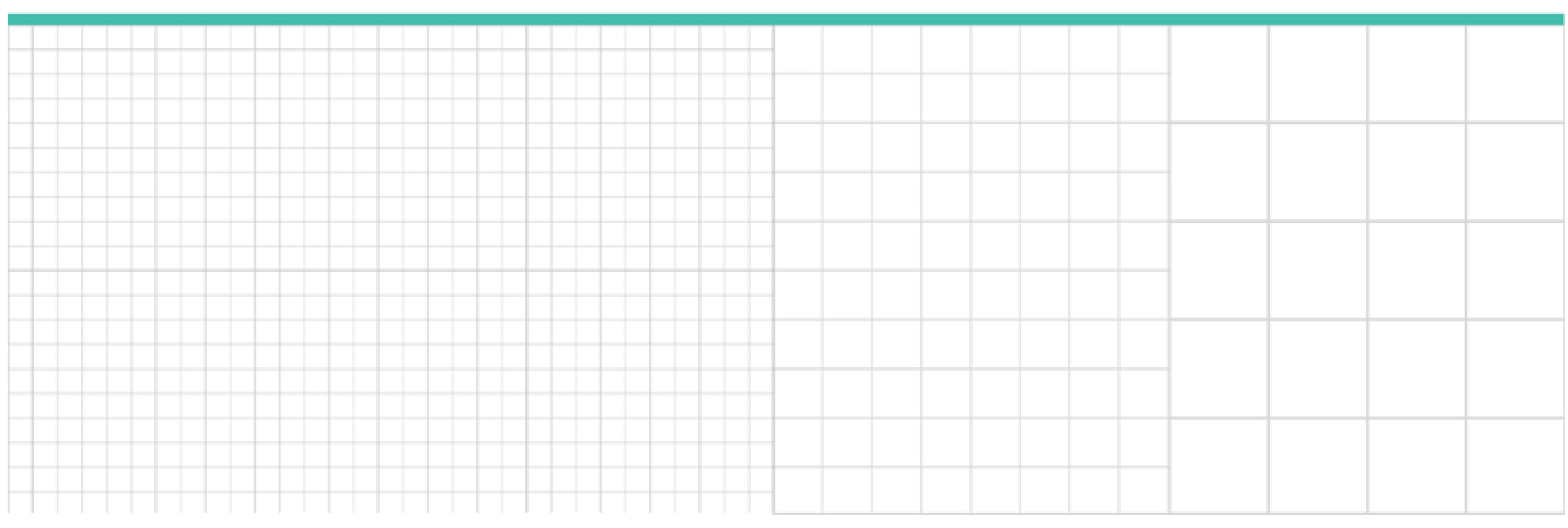
Benefits Guide: Basics

Requirements for Qualified Retirement Plans, Accrual Rules



Benefits Guide: Basics
Qualified Retirement Plans

Accrual Rules

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(10) ACCRUAL RULES BASICS

(10) The Basics —

Benefit Accrual: Benefit accrual refers to the rate at which benefits are earned by employees who are pension plan participants. The concept is distinct from vesting, which refers to the point at which accrued benefits under the plan become nonforfeitable to the participant. The tax code limits the amount of maximum annual benefits a participant can accrue in a defined benefit plan. [1]

[1] I.R.C. § 411(a)(7), 411(b); ERISA § 204, § 3(23); 26 C.F.R. § 1.411(b)-1.

Years of Participation: Accrual rules take into account only those years of service during which employees actually participated in the plan. Consequently, benefits accrue for each “year of participation" in the plan. Generally, a year of participation is 1,000 hours of service, or its equivalent, worked in any 12-month period.

Rules on Accruals: Accrued benefits cannot decrease because of increasing age or service, accrual cannot be stopped because participants reach a certain age, and plan amendments generally cannot reduce benefits already accrued. Reduction or elimination of future accrued benefits is allowed provided the participants get adequate notice. For more, see *Anti-Cutback Rules: Reducing Accrued Benefits Basics*.

Additional Resources: TM Portfolio 351: Plan Qualification-Pension and Profit Sharing Plans; Employee Benefits Law 5.V.: Vesting and Benefit Accrual Rules; Employee Benefits Guide: *Contribution and Benefit Limits*; *Participation Requirements*; *Coverage Requirements*; *Vesting Rules*; *Key Employee and Top Heavy Provisions*.

(20) ACCRUED BENEFIT REQUIREMENTS

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(10) **Accrued Benefit Requirement Basics —**

In a defined benefit plan, the accrued benefit is the present value of the participant's retirement benefit under the plan's benefit formula. For example, the accrued benefit might be expressed as the present value of 5 percent of compensation per year of participation. The accrued benefit usually is expressed as an annual benefit beginning at normal retirement age. [3]

[3] I.R.C. § 411(a)(7).

The rules are intended to provide that benefits are earned regularly throughout an employee's years of plan participation, rather than being backloaded; i.e. earned primarily in the last few years of employment. Backloading favors highly compensated employees because they tend to have more years of service than non-highly compensated employees. By requiring benefits to accrue regularly, defined benefit plan accrual rules provide that plan participants have a meaningful amount of benefit in which to vest throughout that employee's career. [4]

[4] I.R.C. § 411(b)(1).

An accrued benefit derived from a rollover from a defined contribution to a defined benefit plan must be nonforfeitable under I.R.C. § 411(a). Under Rev. Rul. 2012-4, if an annuity amount attributable to the rollover contribution is equal to the amount determined by applying the interest and mortality factors under I.R.C. § 417(e)(1), the amount will be treated as nonforfeitable under § 411(a). However, if the amount attributable to the rollover contribution is less than that which would be produced by applying those factors, the defined benefit plan would violate § 411(a) and be disqualified. [5] For more information about annuities, see *Qualified Survivor Annuities*.

[5] Rev. Rul. 2012-4; I.R.C. § 417(e)(1).

In October 2017, the IRS issued regulations prescribing mortality tables for use together with other actuarial assumptions to calculate the present value of a stream of expected future benefit payments for purposes of determining a defined benefit plan's minimum funding requirements. The tables apply to plan years beginning on or after Jan. 1, 2018. Under the regulations, a plan sponsor can apply for IRS approval to use mortality tables specific to the plan for minimum funding purposes instead of using the generally applicable mortality tables. In certain circumstances, a plan sponsor that is not using plan-specific mortality tables can delay the application of the new tables. [6]

[6] 26 C.F.R. § 1.430(h)(3)-1.

To meet the benefit accrual requirements, the rate of accrual under the defined benefit plan must meet one of three specific accrual patterns: the 3 percent rule, the 133 1/3 percent rule, or the fractional rule. [7]

[7] I.R.C. § 411(b)(1).

If a defined benefit plan entitles an annuitant to a COLA, it must also provide the COLA's actuarial equivalent to a participant who chooses instead to receive his pension in the form of a one-time lump-sum distribution, the U.S. Court of Appeals for the Seventh Circuit ruled. In so finding, the appeals court rejected the plan's argument that the COLAs were “enhancements" for annuitants,

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rather than accrued benefits.[8]

[8] *Williams v. Rohm and Haas Pension Plan,* 497 F.3d 710, 41 EBC 1585 (7th Cir. 2007).

Practice Tip : The plan should understand its accrued benefit formula to make sure that participants are credited with their earned benefits and assure the plan's systems properly reflect and implement the formula.

(20) **Maintaining and Continuing Accrual** —

Even if a defined benefit plan passes one of the three accrual tests, it will not qualify if it decreases a participant's accrued benefit on account of increasing age or service.[9] In addition, a qualified plan cannot exclude an employee from participation on account of being hired too close to normal retirement age. Thus, an employee's benefit under a defined benefit plan generally cannot be discontinued or reduced in rate because the employee has attained a specified age.[10]

[9] I.R.C. § 411(b)(1)(G); ERISA § 204(b)(1)(G).

[10] I.R.C. § 411(b)(1)(H); ERISA § 204(b)(1)(H).

The prohibition does not affect “bridge” or supplemental benefits given to employees to bridge the gap between retirement and Social Security eligibility. Therefore, employers can reduce or eliminate these bridge benefits when Social Security payments begin.

Although accrual cannot be stopped because an employee has attained a certain age, a plan can limit the amount of benefits provided or limit the number of years of participation taken into account for determining the benefits.

Participants who delay retirement and work past normal retirement age can receive the actuarial equivalent of an in-service distribution of benefits instead of accrual, if the participant is receiving required minimum distributions. If the participant has not begun to receive benefits by the end of the plan year, then the continued accrual requirement can be met by adjusting the benefit payable under the plan during the plan years attributable to the delay. The subsidized portion of an early retirement benefit can be ignored in the benefit accrual.

Practice Tip: The plan should assure the accrued benefit formula does not decrease on account of increased age or service, and review formula rates and years of service rules to assure compliance.

Practice Tip: If a cap or limitation on accruing benefits is in place, the limit must not be based on age, but rather must be based on years of service or an overall benefit value cap.

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(30) **Attributing Employee Contributions for Vesting Purposes —**

Accrued benefits in qualified pension plans must be attributed between employer and employee contributions, particularly for vesting purposes (as employees are always 100-percent vested in their own contributions). [11]

[11] I.R.C. § 411(c).

In a defined benefit plan, however, the accrued benefit attributable to employee contributions is determined by:

- dividing the total of employee contributions, minus withdrawals, by the total of employer contributions, minus withdrawals; and
- multiplying the result by the employee's total accrued benefit.

The result is the employee's accrued benefit attributable to employee contributions. Whatever amount of the employee's total benefit remains is the employee's accrued benefit attributable to employer contributions. [12]

[12] 26 C.F.R. § 1.411(c)-1(c)(1).

The interest rate used in accumulating contributions is prescribed under I.R.C. § 417(e)(3), as amended by the Omnibus Budget Reconciliation Acts of 1987 (OBRA ‘87) and 1989 (OBRA ‘89), which changed the accumulation of employee contributions and the conversion of those contributions to employee-derived accrued benefits The rate is the annual rate of interest on 30-year Treasury securities for the month before the date of distribution. RPA ‘94 also specified the mortality table to be used. [13]

[13] I.R.C. § 417(e)(3).

The accrued benefit derived from employee contributions is expressed as a straight-life annuity commencing at normal retirement age of 65. Conversions to other forms of benefit or other retirement ages are required. Treasury Department regulations define the appropriate conversion factors. [14]

[14] 26 C.F.R. § 1.411(c)-1(c)(2).

(30) **ACCRUAL BENEFIT FORMULAS**

(10) **Accrued Benefit Formula Basics —**

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I.R.C. § 411(b)(1) provides that a defined benefit plan must satisfy one of the three accrual rules: the 3 percent method, the 133 1/3 percent rule, or the fractional rule. Under a limited exception, certain plans that determine a participant's benefits as the greatest of the benefits determined under two or more separate formulas can demonstrate satisfaction of the 133 1/3 percent rule by demonstrating that each separate formula satisfies the 133 1/3 percent rule. [15]

[15] I.R.C. § 411(b).

Under Treasury Department rules, when a plan determines the accrued benefit under more than one plan formula, it must aggregate the accrued benefits under one of three accrual rules. [16]

[16] 26 C.F.R. § 1.411(b)-1(a)(1).

However, a plan is ineligible for separate testing if the IRS commissioner determines that the plan's use of separate formulas with different bases is structured to evade the general requirement to aggregate formulas under § 1.411(b)-1(a)(1). This might be the case if the differences between the bases of the separate formulas were minor. [17]

[17] 26 C.F.R. § 1.411(b)-1(a)(1).

Effective on or after Jan. 1, 2012, or an earlier date if the taxpayer elects, a limited exception applies to the accruals for defined benefit pension plans in cases where plan benefits are determined on the basis of the greatest of two or more separate formulas, such as converted cash balance plans. [18]

[18] 26 C.F.R. § 1.411(b)-1(b)(2)(ii)(G).

For more, see *Accrued Benefits in Cash Balance Plans*.

> ***Practice Tip:*** If necessary in order to comply with one of the accrued benefit formulas, the plan should obtain actuary or other consultant confirmation of compliance.

(20) **Accrued Benefit in Defined Benefit Plans: 3 Percent Method** —

In a defined benefit plan, the accrued benefit is the benefit derived from the benefit formula in the plan, such as the present value of X percent of compensation per year of service.

Under the 3 percent method, the accrued benefit to which a participant is entitled upon separation from service cannot be less than:

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• 3 percent of the normal retirement benefit to which the participant would be entitled if participation began at the earliest possible entry age under the plan (when there is no minimum age requirement, the earliest possible entry age is considered to be zero) and worked continuously until the earlier of age 65 or the plan's normal retirement age; multiplied by the number of years (not in excess of 33 1/3) that the individual participated in the plan. [19]

[19] I.R.C. § 411(b)(1)(A); ERISA § 204(b)(1)(A).

Example: *(3 percent requirement not met):* A corporation's defined benefit benefit plan provides an annual retirement benefit commencing at age 65 or $4 per month for each year of participation. As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. The plan provides for no limit on the number of years of credited service. A 40-year-old participates in the plan. Applying the 3-percent method, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit of $1,920 [40×(12×$4)]. To satisfy the 3-percent method, the participant must have accrued an annual benefit of at least $691 [0.03×($1,920×12)] as of the close of the plan year. Under this plan, the participant is entitled to an accrued benefit of $576 [(12×12)×$4] as of the close of the plan year. Thus, his accrued benefit does not satisfy the 3-percent method. [20]

[20] 26 C.F.R. § 1.411(b)-1(iii).

Example: *(3 percent requirement satisfied):* Assume the same facts as in the first example, except that plan provides that only the first 30 years of participation are taken into account. Under the 3-percent method, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age under the plan (25) and served continuously until normal retirement age (65) is an annual benefit of $1.440 [30×$48]. The plan does not satisfy the 3-percent requirement unless the participant has accrued an annual benefit of at least $518 [0.03×($1,440×12)] as of the close of the plan year. Under the plan, the participant is entitled to an accrued benefit of $576 [(12×$48]. Thus, his accrued benefit provided under the M Corporation plan satisfies the 3 percent rule. [21]

[21] 26 C.F.R. § 1.411(b)-1(iii).

The 3-percent requirement prevents a plan from reducing the benefit to which a participant is entitled by considering only compensation from the participant's lower-earning earlier years of employment. [22]

[22] 26 C.F.R. § 1.411(b)-1(b).

(30) **Accrued Benefits in Defined Benefit Plans: 133 1/3 Percent Method** —

The 133 1/3 percent method used for defined benefit plans compares earlier and later service to guard against backloading. [23]

[23] ERISA § 204(b)(1)(B).

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Under this rule, a plan must satisfy two requirements:

- the accrued benefit at normal retirement age must equal the plan's normal retirement benefit; and
- the annual rate at which any participant can accrue retirement benefits payable at normal retirement age cannot be more than 133 1/3 percent of the annual rate at which the participant can accrue benefits in any prior year.[24]

[24] I.R.C. § 411(b)(1)(B); ERISA § 204(b)(1)(B).

The following factors are considered in applying the test:

- The plan does not have to take into account early retirement, disability, and death benefits.
- Changes in the accrual rates that do not apply to current participants are ignored for purposes of this test.
- Social Security, compensation, and other factors used in computing benefits are treated as remaining constant in all future years.[25]

[25] 26 C.F.R. § 1.411(b)-1(b)(2)(ii).

A plan amendment increasing benefits is treated as having been in effect for all prior plan years, to encourage benefit increases.[26]

[26] 26 C.F.R. § 1.411(b)-1(b)(2)(ii)(A).

(40) **Accrued Benefits in Defined Benefit Plans: The Fractional Method** —

The fractional method requires the benefit of a participant who quits the job before attaining normal retirement age to be proportional to the benefit that would have been received at the normal retirement age. The test compares an employee's years of participation in the plan to the total years the employee would have participated in the plan when reaching the normal retirement age.[27]

[27] I.R.C. § 411(b)(1)(C); ERISA § 204(b)(1)(C).

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(40) YEAR OF PARTICIPATION FOR ACCRUAL PURPOSES

(10) Year of Participation Basics —

A year of participation for accrual purposes includes only actual plan participation. A plan can elect not to count as years of participation any years during which an employee works fewer than 1,000 hours of service in any 12-month period.

However, when the plan's accrual computation period is different from its participation computation period, an employee admitted to participation must accrue benefits retroactive to the employee's admission date.

Example: If a plan has a one-year participation holdout rule for former employees who return to work for the employer, such an employee will have to be given retroactive accrual credit for the holdout year on re-admission to the plan.[28] For more on years of service for participation, see *Participation Requirements* and *Coverage Requirements*.

[28] I.R.C. § 411(b)(4); ERISA § 204(b)(4); 29 C.F.R. §2530.204-2(c)(1).

Practice Tip: Years of participation for each plan year must be tracked accurately for correct computation of benefit accruals. The plan must also define and implement the plan's break-in-service rules, including providing retroactive credit for any holdout years.

(20) Service Requirement for Accrual Purposes —

A plan can provide that employees must perform more than 1,000 hours of service in a 12-month computation period before crediting them with a full year of service for accrual purposes, as long as the plan provides for at least ratable benefit accrual for any employee who completes less than the required number of hours but more than 1,000 hours of accrual service.[29]

[29] 29 C.F.R. § 2530.204-2(c)(1).

A plan's method of crediting service for accrual purposes can have the effect, however, of prorating benefits to reflect less than full-time service or less than maximum compensation, as the case may be. In that situation, the plan cannot reduce accruals by crediting less than full years of participation, because this would result in double proration—once for earning compensation for only part of a year and again for failing to accrue a full year of service during the computation period. Rather, these plans must credit, except when service can be disregarded because it less than 1,000 hours, less-than-full-time employees with a full year of participation for the purpose of accrual of benefits.[30]

[30] 29 C.F.R. § 2530.204-1; 29 C.F.R. § 2530.204-2(d).

Practice Tip: The plan should accurately track accrued service credit on a plan year basis, and provide ratable benefit

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accrual for persons who work less than the overall hours of service needed to obtain on full year's accrual service credit.

(30) **Equivalencies for Determining Accrual Service** —

A plan can use any of the equivalencies approved by the Labor Department for counting service for participation purposes in determining accrual service. Further, a plan need not use the same equivalency for accrual purposes that it uses for participation or vesting.[31]

[31] 29 C.F.R. § 2530.200b-3.

For more on equivalencies, see *Vesting Rules*; *Participation Requirements*; and *Coverage Requirements*.

(40) **Determining Accruals for Part-Time Employees** —

Part-time employees must be given a proportionate amount of the accruals to which they would have been entitled had they worked full-time.[32]

[32] I.R.C. § 411(b)(4)(B).

(50) **ANTI-CUTBACK RULES**

(10) **Anti-Cutback Rules: Reducing Accrued Benefits Basics** —

I.R.C. § 411 anti-cutback rules in general prohibit sponsors of qualified pension plans from making plan amendments that would decrease accrued benefits, although amendments can reduce future accruals. A multiemployer pension plan in declining and critical status, however, can suspend benefits for certain retirees, notwithstanding the anti-cutback rule (see *Reduction of Benefits for Plans in Critical and Declining Status*). The anti-cutback rules do not apply to welfare benefits.

An amendment under I.R.C. § 411(d)(6) will reduce already accrued benefits if it:

- eliminates or reduces an early retirement benefit (such as an employee's right to receive actuarially reduced benefits at a designated early retirement age);
- eliminates or reduces a retirement-type subsidy (such as an employee's right to receive an early retirement benefit which is not actuarially reduced); or
- eliminates an optional form of benefit (such as a lump-sum payment).

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The plan provisions taken into account in determining whether future accrual rates are reduced include:

• the dollar amount or percentage of compensation on which benefit accruals are based;

• method of determining average compensation for calculating benefit accruals;

• the amount of permitted disparity;

• the definition of service or compensation taken into account;

• the definition of normal retirement age in a defined benefit plan;

• the exclusion of current participants from future participation;

• benefit offset provisions;

• minimum benefit provisions;

• the formula for determining the amount of contributions and forfeitures allocated to participants' accounts in defined contribution plans; and

• actuarial assumptions used to determine contributions in a target benefit plan.

ERISA § 204(g) contains anti-cutback rules that are parallel to those in I.R.C. § 411(d)(6). Regulations issued under that code section apply as well for purposes of ERISA § 204(g).

An exception to the funding provisions in I.R.C. § 412(d)(2) allows defined benefit or money purchase plan sponsors to apply for retroactive reduction in accrued benefits because of substantial business hardship for which a funding waiver is unavailable or inadequate.

Practice Tip: A plan amendment must not decrease accrued benefits or improperly cut back benefits retroactively. Any change, modification or elimination of benefit forms, participation rules or service accrual should be carefully scrutinized.

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(20) **Court Rulings in Anti-Cutback Cases** —

The courts have addressed the anti-cutback rules in a number of cases.[33]

[33] See Smart Code® for the latest cases.

Amending Welfare Plan Impacted Pension Plan: Trustees of a collectively bargained welfare plan illegally reduced plan participants' pension benefits when they amended the welfare plan to make participants ineligible for retiree health benefits if they elected to receive their pension benefits in a lump-sum distribution the U.S. Court of Appeals for the Third Circuit ruled.[34]

[34] *Battoni v. IBEW Local Union No. 102 Employee Pension Plan*, 594 F.3d 230, 48 EBC 1833 (3d Cir. 2010).

In so finding, the court rejected the fund trustees' contention that there could be no violation of ERISA's anti-cutback rule because the amendment applied only to participants' welfare benefits, not their pension benefits.

The amendment to the welfare plan violated the anti-cutback rule because it "constructively amended" the pension plan by conditioning receipt of the lump-sum pension benefit, an accrued benefit, on surrendering health care benefits provided by the welfare plan, the court found.

Plan Reinterpretation Violated Anti-Cutback Rule: An employer's reinterpretation of an ERISA pension plan's provisions to reduce retired workers' benefits constituted a plan amendment that violated ERISA's anti-cutback provision by reducing participants' accrued benefits after they began receiving monthly payments, the Third Circuit held. The appeals court declined to address the level of judicial deference owed to ERISA fiduciaries that reinterpret plan provisions, ruling instead that the employer's reinterpretation was erroneous under any level of deference because it clearly contradicted the terms of the relevant plan documents.[35]

[35] *Cottillion v. United Ref. Co.*, 781 F.3d 47, 2015 BL 73177; 59 EBC 2669 (3d Cir. 2015).

Severance Plan Amendment Did Not Violate Anti-Cutback Rule: A severance plan amendment that preconditioned an employee's receipt of benefits on the employee signing a release waiving all employment-related claims did not violate the plan's anti-cutback provision, because the plan amendment was simply a condition precedent, and did not cause a reduction or elimination of the employee's benefits, the U.S. Court of Appeals for the Eleventh Circuit ruled.[36]

[36] *Loskill v. Barnett Banks Inc. Severance Pay Plan*, 289 F.3d 734, 27 EBC 2416 (11th Cir. 2002).

Failing to Apply Correct Interest Rate Violated Anti-Cutback Rule: An employer and its pension plan violated the anti-cutback rules when, following a plan amendment, they failed to apply an appropriate interest rate to calculate the present value of

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subsidized early retirement benefits attributable to service before the amendment, the U.S. Court of Appeals for the Sixth Circuit ruled.[37]

[37] *Rybarczyk v. TRW Inc.*, 235 F.3d 975, 25 EBC 1577 (6th Cir. 2001).

Plan Amendment Decreasing Benefits Added After Retirement Did Not Violate Anti-Cutback Rule: The term "accrued benefit," as defined in ERISA and the I.R.C., does not encompass benefit increases that are added to a plan after a participant retires, the U.S. Court of Appeals for the Sixth Circuit ruled. Thus, a multiemployer pension fund did not illegally reduce retired fund participants' accrued benefits when the plan was amended in 2002 to take away a benefit increase that had been granted three years earlier, the court held.[38]

[38] *Thornton v. Graphic Communications Conference of Int'l Brotherhood of Teamsters Supplemental Retirement and Disability Fund*, 566 F.3d 597, 46 EBC 2292 (6th Cir. 2009).

Prohibiting Re-Employment Did Not Violate Anti-Cutback Rule: A multiemployer pension fund did not illegally reduce fund participants' benefits when it amended the fund's provisions regarding its right to recoup benefit payments made to participants who engaged in prohibited re-employment, the U.S. Court of Appeals for the Seventh Circuit ruled.[39]

[39] *Herman v. Central States, Southeast and Southwest Areas Pension Fund*, 423 F.3d 684, 35 EBC 2397 (7th Cir. 2005).

The Central States, Southeast and Southwest Areas Pension Fund prohibited fund participants from engaging in certain types of employment while receiving benefits. If a participant engaged in such employment, the fund would suspend the participant's benefits until he or she ceased working in prohibited re-employment.

Prior to March 2002, the fund's language stated that the fund had the "right to recover" from any participant engaged in prohibited re-employment any benefit payments made "due to a mistake." The fund was amended in March 2002 to authorize it to seek "restitution" of payments that a participant "was not entitled to receive" because of the participant's engagement in prohibited re-employment.

The plan amendments only changed the terminology used to explain the fund's right to repayment of benefits, saying that the change did not in any way alter the fund's right to recover benefits paid in error while the participants engaged in prohibited re-employment.

Amending a Pension Plan to Reduce Early Retirement Benefits Violated Anti-Cutback Rule: A multiemployer pension plan expanded its definition of disqualifying employment, resulting in a suspension of benefits for retired participants under age sixty who were receiving a monthly benefit. The amendment resulted in the shrinking of the value of participants' pension rights and reducing promised benefits, and as a result violated the anti-cutback rule, the *U.S. Supreme Court ruled.*[40]

[40] *Central Laborers' Pension Fund v. Heinz,* 541 U.S. 739 (2004).

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Anti-Cutback Rule Not Applicable in PBGC Involuntary Plan Termination: ERISA's anti-cutback provisions apply only to a situation in which an employer retains control over the plan, not when the PBGC terminates a plan involuntarily, the U.S. Court of Appeals for the D.C. Circuit ruled. The PBGC involuntarily terminated the employer's four defined benefit plans prior to the accrual of shutdown benefits—a decision the PBGC said would avoid adding $96 million in unfunded liabilities to the plan. The PBGC offset the employees' monthly defined benefit payments by the amount distributed from the defined contribution portions of the plans. Because this was an involuntary termination, and not the employer retaining control over the plan, the D.C. Circuit ruled that this offset did not violate ERISA § 204(g). [41]

[41] *Deppenbrook v. PBGC*, 778 F.3d 166, 2015 BL 43167, 59 EBC 2631 (D.C. Cir. 2015).

Retroactive Post-Plan Termination Amendment Decreasing Benefits Violated Anti-Cutback Rule: An employer amended the lump-sum calculation method a month after it terminated its pension plan, decreasing the value of benefits by $2.1 million. The anti-cutback rule was implemented to prevent changes in actuarial assumptions that would likely lead to smaller lump-sum payments, the U.S. District Court for the District of Columbia ruled Thus enforcement of the PBGC's determination that the plan recalculate the lump-sum payments and made additional contributions. [42]

[42] *Royal Oak Enterprises, LLC v. Pension Benefit Guaranty Corporation,* 78 F. Supp. 3d 431, 60 EBC 1618 (2015).

(30) **Anti-Cutback Rules: Plan Sponsors in Bankruptcy** —

Effective for plan amendments that are adopted and effective after Nov. 8, 2012, a defined benefit plan sponsor that is a debtor in a bankruptcy proceeding is allowed to eliminate a lump-sum distribution—or other optional form of benefit providing for accelerated payments—if:

- the plan's enrolled actuary has certified that, for the plan year for which the amendment is being sought, the plan's adjusted funding target attainment percentage is less than 100 percent;

- the plan is not permitted to make any “prohibited payment"—generally a payment that is in excess of the monthly amounts payable under a single life annuity—because the plan sponsor is a debtor in a bankruptcy case;

- the bankruptcy court handling the case has issued an order stating that the adoption of the amendment is necessary to avoid a distress termination or an involuntary termination of the plan prior to completion of the bankruptcy case; and

- the Pension Benefit Guaranty Corporation has determined that the amendment is necessary to avoid a distress or involuntary termination of the plan prior to completion of the bankruptcy case and that the plan assets are insufficient to cover all PBGC-guaranteed benefits. [43]

[43] 26 C.F.R. § 1.411(d)-4, Q&A-2(b)(2)(xii).

In addition, if a plan sponsor under bankruptcy protection eliminates a lump-sum distribution option and the plan does not offer

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other optional forms of benefit that provide "substantial" survivor benefits, the plan sponsor can add these benefits. These can include other optional benefit forms that are prohibited payments under I.R.C. § 436(d)(5) as part of the same amendment that eliminates the single-sum distribution option (or other optional form of benefit that includes a prohibited payment).[44]

[44] 77 Fed. Reg. 217 (Nov. 8, 2012).

All provisions of such a plan amendment (including both the elimination of the single-sum distribution option and the addition of optional forms of benefit that provide substantial survivor benefits) will be considered together for purposes of determining whether the plan amendment will be permitted to take effect in accordance with the limits of § 436(c) on plan amendments that would increase benefit liabilities.

Plan participants who may be affected by the plan amendment are entitled to a court hearing on whether the amendment is necessary to avoid plan termination. However, under the final rule, "a failure to notify a particular participant or beneficiary does not automatically invalidate the amendment."[45]

[45] 77 Fed. Reg. 217 (Nov. 8, 2012).

(40) **Anti-Cutback Rules: Required Distributions** —

The 1996 Small Business Job Protection Act repealed the I.R.C. § 401(a)(9) requirement that employers must start making distributions to plan participants turning age 70 1/2 even if those participants are active employees. However, employers could not take advantage of this repeal by amending their plans without running afoul of the I.R.C. § 411 anti-cutback rules, because plan amendments that eliminate an optional form of benefit are treated as reducing accrued benefits.

Under I.R.C. § 401(a)(9), for a plan to remain qualified, distributions must begin no later than the "required beginning date."

I.R.C. § 401(a)(9), as amended by SBJPA, provides that distributions are to commence to such employees by April 1 of the calendar year following the calendar year in which the employee retires from employment with the employer maintaining the plan.

IRS Announcement 97-24 gave employers two choices on how to deal with the SBJPA amendment and their obligation to follow the anti-cutback rules. Employers could give their employees (other than 5-percent owners) who turn age 70 1/2 the choice of beginning their distributions at age 70 1/2 or deferring their distributions until they retire. Alternatively, employers could amend their plans to eliminate the right to preretirement distributions for future accruals only, leaving all current participants the right to receive preretirement distributions. Offering either of these options as to future accruals would complicate plan administration.

IRS Announcement 97-24 applies to employers with master, prototype, or regional prototype plans. If a conforming amendment is not an available option under the sponsor's prototype plan document, the required amendment can result in the loss of prototype status.

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26 C.F.R. § 1.411(d)-4, Q&A-10, permits a plan amendment that eliminates preretirement distributions after age 70 1/2 without violating the anti-cutback rules under the following conditions:

• The amendment eliminating the optional form of benefit applies only to benefits for employees who attain age 70 1/2 in or after a calendar year, as specified in the plan amendment, that begins after the later of Dec. 31, 1998, or the adoption of the amendment; and

• The plan does not preclude an employee who retires after the calendar year in which the employee attains age 70 1/2 from receiving benefits in any of the same optional forms of benefit (except for the difference in the timing of the commencement of payments) that would have been available had the employee retired in the calendar year in which the employee attained age 70 1/2.[46]

[46] 26 C.F.R. § 1.411(d)-4, Q&A-10.

(60) REDUCTION OF FUTURE ACCRUALS

(10) Reduction of Future Accruals Basics —

Under Treasury Department rules, a pension plan can be amended to eliminate or reduce future accrued benefits as of the later of the date of the amendment's adoption date or effective date without violating the anti-cutback rule. Under ERISA § 204(h), plan administrators must notify affected parties before amending the plan to eliminate or reduce future benefit accruals, including early retirement benefits and retirement-type subsidies. Amendments to defined benefit plans affecting the rate of future benefit accrual are those affecting the annual benefit commencing at normal retirement age for a year.[47]

[47] 26 C.F.R. § 1.411(d)-4, Q&A-2(a).

26 C.F.R. § 54.4980F-1 and 26 C.F.R. § 1.411(d)-3 set forth timing rules for providing an ERISA § 204(h) notice for a retroactive plan amendment that is permitted to be effective before the applicable amendment date. Section 54.4980F-1 also provides guidance relating to changes made to § 4980F by the Pension Protection Act. The notice requirements of I.R.C.§ 4980F generally parallel the notice requirements of ERISA § 204(h).[48]

[48] 26 C.F.R. § 54.4980F-1; 26 C.F.R. § 1.411(d)-3.

An amendment to convert a money purchase pension plan to a profit-sharing or other individual account plan is, in all cases including mergers, consolidations, or transfers, deemed to trigger the notification requirements as a significant reduction in the rate of future benefit accruals. Plans amended before termination to reduce significantly the rate of future benefit accrual must provide ERISA § 204(h) notices.[49]

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[49] 26 C.F.R. § 54.4980F-1; 26 C.F.R. § 54.4980F-1, Q&A-8 and 10.

Practice Tip: The plan must provide to participants an ERISA § 204(h) notice for plan amendment that freeze or reduce benefit accruals. If accrual benefit rates are reduced, the reduction must be prospective only.

(20) **When Is a §204(h) Notice Not Required** —

A notice under ERISA § 204(h) is not required for:

- plan amendments that do not affect benefits beginning at normal retirement age or future allocations to participants' accounts, or do not do so significantly;
- a reduced single-sum distribution resulting from an amendment to a traditional defined benefit plan to substitute the prescribed actuarial assumptions under § 417(e)(3) (determination of present value), as amended by the PPA, for the pre-PPA actuarial assumptions under § 417(e)(3);
  - participants or alternate payees whose benefit accruals are unaffected by the amendment (such as terminated vested participants who are not entitled to accrue future benefits in the plan);
  - hourly employees
- employee organizations that do not represent at least one participant for whom the notices are required; and
- employees who are not yet plan participants.[50]

[50] 26 C.F.R. § 54.4980F-1, Q&A-10.

(30) **How and to Whom Must the § 204(h) Notice Be Provided?** —

A plan administrator must provide a § 204(h) notice in a manner calculated to result in the actual receipt of a notice. Posting is not deemed to be sufficient. First-class mail delivery to the last known address is acceptable. The § 204(h) notice may be enclosed or combined with other notices provided by the employer or plan administrator. The notice may also be provided

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through an electronic method, providing the notice is actually received by the applicable individual or the plan administrator takes appropriate and necessary measures reasonably calculated to ensure actual receipt of the notice.[51] The notice must be provided to:

[51] 26 C.F.R. § 54.4980F-1, Q&A-13.

- Plan participants,
- Employee organizations representing plan participants,
- Any alternate payees under qualified domestic relation orders, and
- individuals reasonably expected to be participants or alternate payees on the effective date of the § 204(h) amendment.

The § 204(h) notice can also be provided to an individual who is designated in writing by a § 204(h) notice recipient. The final rules provide that a facts and circumstances test will be applied to determine whether an individual or organization is a § 204(h) notification recipient.[52]

[52] 26 C.F.R. § 54.4980F-1, Q&A-10(e).

In addition, plan sponsors must send the § 204(h) notice to *contributing employers*, as well as other affected parties. A contributing employer is an employer in a multiemployer plan that has an obligation to contribute to a plan under a collective bargaining agreement, or as the result of a duty under another labor-management relations law, excluding withdrawal liability or delinquent contributions.[53]

[53] 26 C.F.R. § 54.4980F-1, Q&A-10 and 13.

(40) **Deadline for Providing a §204(h) Notice** —

Generally, the ERISA § 204(h) notice must be provided 45 days prior to the effective date of an amendment to the plan. Exceptions to the 45-day general rule include:

- Small plans can provide notification 15 days before the effective date of a plan amendment.
- Multiemployer plans can provide notification 15 days before the effective date of an amendment.

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• For business transactions in connection with an acquisition or disposition, the plan can provide notification of an amendment 15 days before the effective date of an amendment.

• When a business transaction causes adoption of an amendment that significantly reduces only early retirement benefit or retirement type subsidies, but does not significantly reduce the rate of future benefit accruals, the notification can be made no later than 30 days after the effective date of the amendment. [54]

[54] 26 C.F.R. § 54.4980F-1, Q&A-9.

(50) **Content and Form of a §204(h) Notice** —

The § 204(h) notification must be written in a manner calculated to be understood by the average plan participant and must include:

• a description of the benefits formula prior to the amendment, a description of the benefits formula after the amendment to the plan, and the effective date of the amendment;

• sufficient information to determine the approximate magnitude of the reduction and bound the range of reductions; and

• when the expected reduction is not uniformly applied, which general classes to whom the reduction in benefits is expected to apply. [55]

[55] 26 C.F.R. § 54.4980F-1, Q&A-11.

The content requirements are generally deemed satisfied if the notice includes one or more illustrative examples showing the approximate magnitude of the reduction. [56]

[56] 26 C.F.R. § 54.4980F-1, Q&A-11.

For an amendment that reduces an early retirement benefit or retirement-type subsidy, other than as a result of an amendment reducing the rate of future benefit accrual, the notice must describe:

• how the early retirement benefit or subsdiary is calculated from the accrued benefit before the amendment;

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- how the benefit or subsidy is calculated from the accrued benefit after the amendment; and

- the effective date of the amendment.[57]

[57] 26 C.F.R. § 54.4980F-1, Q&A-11(a)(3)(i).

Example: Under a plan with a normal retirement age of 65, the change is from an unreduced normal retirement benefit at age 55 to an unreduced normal retirement benefit at age 60 for future accrued benefits, actuarially adjusted for future benefits to the extent that the early retirement benefit begins before age 60. Thus, the notice must state the change and specify factors that apply in calculating the actuarial reduction (for example, a 5% per year reduction applies for early retirement before age 60).[58]

[58] 26 C.F.R. § 54.4980F-1, Q&A-11(a)(3)(ii).

(60) **Other Notice Filings That Satisfy §204(h) Notice Requirement —**

Under 26 C.F.R. § 54.4980F-1, Q&A-9, if the plan provides one of the following notices, containing the required content and filed on time, the plan is treated as satisfying a § 204(h) notice requirement with respect to a § 204(h) future accrued benefit reduction:

- a notice required under Rev. Proc. 94-42 relating to retroactive plan amendments that reduce accrued benefits described in § 412(d)(2);

- a notice required under ERISA § 101(j) if an amendment is adopted to comply with the benefit limitation requirements of § 436;

- a notice required under I.R.C. § 432(b)(3)(D) for an amendment adopted to comply with the benefit restrictions under § 432(f)(2);

- a notice required under I.R.C. § 418D (ERISA § 4244A(b), relating to relating to the reduction or elimination of accrued benefits attributable to employer contributions with respect to a multiemployer plan in reorganization;

- a notice required under I.R.C. § 418E (ERISA § 4245(e)), relating to the effects of the insolvency status for a multiemployer plan; and

- a notice required under ERISA § 4281 and 29 C.F.R. § 4281.32 for an amendment of a multiemployer plan reducing [59]

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benefits under ERISA § 4281(c).[59]

[59] 26 C.F.R. § 54.4980F-1, Q&A-9.

(70) **Penalties for Not Filing §204(h) Notices —**

A plan cannot be amended to provide for a significant reduction in the rate of future benefit accrual in the event of an egregious failure by the plan administrator to comply with ERISA's notice requirement. In the case of an egregious failure to comply with ERISA § 204(h) notification requirements, a plan participant will be entitled to the greater of the benefit regardless of the plan amendment.[60] The regulations define an egregious failure as:

[60] ERISA § 204(h)(6)(A).

• one within the control of the plan sponsor; and

• an intentional failure or one that fails to provide most of the individuals with most of the information they were entitled to receive, whether intentional or not.[61]

[61] 26 C.F.R. § 54.4980F-1, Q&A-14(a)(2).

(80) **Tax Code §4980F Notice Requirements —**

The notice requirement of I.R.C. § 4980F covers defined benefit pension plans or plans subject to I.R.C. § 412 minimum funding standards. It does not apply to governmental plans or church plans for which an election to have the plan participation, vesting, and funding rules apply has not been made. It also does not apply to nonqualified defined benefit plans.[62] The notice requirement also does not apply to amendments where the early retirement benefit or retirement-type subsidy is not significant. Nor does the statute define a “significant" early retirement benefit or early retirement subsidy.[63]

[62] 26 C.F.R. § 54.4980F-1, Q&A-3(a).

[63] 26 C.F.R. § 54.4980F-1, Q&A-5(a).

The administrator must provide in the notice, in a manner calculated to be understood by the average plan participant, sufficient information to allow participants to understand the effect of the amendment.[64] The notice must be provided, within a reasonable amount of time before the effective date of the amendment, to each affected participant, each affected alternate payee, and each employee organization representing affected participants. An affected participant or alternate payee is a participant or alternate payee whose rate of future benefit accrual can reasonably be expected to be significantly reduced by the plan amendment.[65]

[64] 26 U.S.C. § 4980F(e).

[65] 26 U.S.C. § 4980F(f)(1).

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Failure to comply with the I.R.C. § 4980F notice requirement will result in imposition of an excise tax of $100 per day per omitted participant and alternate payee on the employer.[66] In the case of collectively bargained multiemployer plans, the plan itself is responsible for reporting and pay the excise tax.[67] No excise tax will be imposed, however, during any period during which any person subject to liability for the tax did not know that the failure existed and exercised reasonable diligence to meet the notice requirement.[68]

[66] 26 U.S.C. § 4980F(b).

[67] 26 C.F.R. § 54.4980F-1, Q&A-15(a).

[68] 26 C.F.R. § 54.4980F-1, Q&A-15(c)(1).

In addition, no excise tax will be imposed on any failure if any person subject to liability for the tax exercised reasonable diligence to meet the notice requirement and such person provided the required notice during the 30-day period beginning on the first date such person knew, or exercising reasonable diligence would have known, that the failure existed.[69]

[69] 26 C.F.R. § 54.4980F-1, Q&A-15(c)(2).

If the person subject to liability for the excise tax exercised reasonable diligence to meet the notice requirement, the total excise tax imposed during a taxable year of the employer cannot exceed $500,000.[70] In the case of a failure due to reasonable cause and not to willful neglect, the Treasury Department can waive the excise tax to the extent that it would be excessive relative to the failure involved.[71] IRS in Delegation Order 7-7 delegated managers in Employee Plans Technical the authority to waive § 4980F excise taxes for failure to satisfy notice requirements.[72]

[70] 26 U.S.C. § 4980F(c)(3).

[71] 26 U.S.C. § 4980F(c)(4).

[72] Internal Revenue Manual, 1.2.46 Delegation Of Authorities For The Rulings And Agreements Process.

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