Cutback the Complexity! Making Sense of the Anti-Cutback Rules

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Anti-Cutback Rules Prohibit:

1) Decreasing an accrued benefit; or

2) Eliminating an optional form of benefit

• Typically find anti-cutback issues:
  – Amendments
  – TPA takeovers
  – Mergers or acquisitions
DB Reducing Benefits

• Accrual formula = Two percent of average compensation times years of participation
• 1,000-hour requirement for year of participation
• Plan sponsor experiencing financial trouble in 2017
• Amend to one percent of average compensation on November 1, 2017?
Poll #1: DB Reducing Benefits

Decreasing an accrued benefit by decreasing formula?

A. Yes
B. No
C. Maybe
D. Don’t Know
DB Reducing Benefits (Continued)

- Yes, protected benefit
- Anti-cutback rules protect benefits accrued as of amendment date
- Accrued benefit 2016 and prior
- 2017? Yes
- Permitted to change future accruals

  Treas. Reg. § 1.411(d)-3(b)(3)

- Changing future accruals = 204(h) notice
- Failure to provide = $100 excise tax

  IRC §4980F(b)(1)
DB Reducing COLAs

• Accrual formula = Two percent of average compensation times years of participation
• Cost of living adjustment (COLA) provided after retirement
• Plan sponsor experiencing financial trouble
• Amend to remove COLAs going forward?
• Decreasing an accrued benefit?
DB Reducing COLAs (Continued)

- Yes, protected benefit
- COLAs considered accrued benefit, which cannot be reduced for future payments

Williams v. Rohm & Haas Pension Plan, 497 F.3d 710 (7th Cir. 2007); Shaw v. International Association of Machinists & Aerospace Workers Pension Plan, 750 F.2d 1458 (9th Cir. 1985)

- Lump-sum payments from terminated plan must take into account post-retirement COLA value

IRS Announcement 95-99
Voluntary Waiver

- Accrual formula = Two percent of average compensation times years of participation
- 1,000-hour requirement for year of participation
- Plan sponsor experiencing financial trouble in 2017
- Owner would like to reduce his accrual to zero percent for the current year
- Amend effective November 1, 2017?
- Decreasing an accrued benefit?
Voluntary Waiver (Continued)

- Yes, protected benefit
- Cannot waive accrued benefit to prevent or eliminate underfunding status
- Distinguish between PBGC allowing owner to forego distribution upon plan termination

PLR 9146005;
Announcement 94-101
Cash Balance Plans

- Conversion from traditional to cash balance
- Wear-away provision adopted
- Benefit at retirement no less than benefit of traditional plan at time of conversion
Poll #2: Cash Balance Plans

Decreasing an accrued benefit with wear-away?

A. Yes
B. No
C. Maybe
D. Don’t Know
Cash Balance Plans (Continued)

- No protected benefit
- Anti-cutback rules protect accrued benefits
- Wear away provisions deal with potential future accruals
- No entitlement to future accruals

Campbell v. BankBoston, N.A., 303 F.3d 1 (1st Cir. 2003)
DC Allocation Formula

- 401(k) profit-sharing plan
- Company has best year ever in 2017
- Plan set up for pro rata PS allocation formula
- Change to cross-tested PS formula effective November 1, 2017?
Poll #3: DC Allocation Formula

Decreasing an accrued benefit by changing formula?

A. Yes
B. No
C. Maybe
D. Don’t Know
DC Allocation Formula (Continued)

- May be protected benefit
- Depends upon allocation conditions
- IRS position: right to allocation formula protected once allocation conditions are satisfied
- Considered “protected allocable share”
- Need to review allocation conditions
DC Allocation Formula (Continued)

- Last-day requirement?
- No protected allocable share until last day of plan year
- 1,000-hour requirement?
- No protected allocable share until hour requirement satisfied
- Full-time employee will work 1,040 in six months
- If both last day and 1,000 hour?
- No protected allocable share until last day of plan year
DC Allocation Formula (Continued)

- No allocation conditions?
- Protected allocable share as soon as participant works one hour
- For discretionary contributions, sponsor has ability to not contribute at all – so isn’t protected allocable share really nothing?
Allocation Conditions

- Executive leaves August 2017
- Front-loaded her salary deferrals
- Discretionary matching contribution
- No allocation conditions on match
- Owner really upset she left and doesn’t want to provide her any additional benefits
- Add a last-day allocation condition?
Poll #4: Allocation Conditions

Decreasing an accrued benefit by changing conditions?

A. Yes
B. No
C. Maybe
D. Don’t Know
Allocation Conditions (Continued)

- Yes, protected benefit
- Protected allocable share as soon as participant works one hour
- If discretionary match is contributed, must include executive
- Alternative is to not provide a match at all

Treas. Reg. § 1.411(d)-4, Q&A 1(d)(8)
DC Safe Harbor Plan

- 401(k) safe harbor plan
- Could be either match or non-elective safe harbor
- Plan sponsor experiencing financial trouble in 2017
- Eliminate effective November 1, 2017?
- Decreasing an accrued benefit?
DC Safe Harbor Plan (Continued)

- Yes, protected benefits
- Anti-cutback rules only protect benefits accrued as of amendment date
- Must provide safe harbor contributions up to amendment date
- Satisfy other conditions under Treas. Reg. § 1.401(k)-3(g)
- No protected benefit to safe harbor contributions after November 1, 2017
- Allowed to change future accruals or even terminate the plan

Treas. Reg. § 1.411(d)-3(b)(3)
Distribution Timing

• Executive leaves August 2017
• Rumored to be starting a competing business
• Completed distribution form
• Plan document states distributions to be paid as soon as possible
• Can you delay payment? For example, amend plan for distributions to paid after the last day of the plan year in which termination occurs?
Poll #5: Distribution Timing

Eliminating an optional form of benefit by changing distribution timing?

A. Yes
B. No
C. Maybe
D. Don’t Know
Distribution Timing (Continued)

• Yes, protected benefit
• Optional form of benefit = distribution alternative available with respect to accrued benefits
• Includes timing of distribution
• Only delay distribution timing for future accruals
• Too late for terminated executive

Treas. Reg. § 1.411(d)-3(g)(6)(ii)(A)
DB Distribution Options

• Plan offers following distribution options:
  – Straight life annuity
  – Life annuity with ten-year certain
  – 100 percent joint and survivor annuity
  – 75 percent joint and survivor annuity
  – 50 percent joint and survivor annuity
  – Lump-sum distribution

• Sponsor wants to narrow options to reduce administrative costs
Poll #6: DB Optional Forms of Benefit

Eliminating an optional form of benefit by removing some of the distribution options?

A. Yes
B. No
C. Maybe
D. Don’t Know
• Potential exception to anti-cutback rules!
• May eliminate redundant optional forms
  – Satisfy redundant elements (i.e., “families of options”)
  – Cannot apply until 180 days after amendment
    Treas. Reg. § 1.411(d)-3(c)
• May also eliminate “noncore” optional forms
  – Cannot be defined as a “core” option
  – Cannot apply until four years after amendment
    Treas. Reg. § 1.411(d)-3(d)
DB Actuarial Assumptions

- Plan’s normal form of benefit is life annuity
- Lump-sum option also available
- Determined by applying six percent preretirement interest
- Amend to increase preretirement interest to eight percent after December 31, 2017?
Yes, protected benefit

Lump sum would be determined as greater of:

- Accrued benefit as of December 31, 2017 applying six percent preretirement interest rate; or
- Total accrued benefit applying eight percent preretirement interest rate

- No anti-cutback if using fluctuating 417(e)(3) rates

Rev. Rul. 81-12

Rev. Rul. 2007-67
DB Early Retirement Benefits

• DB plan offers early retirement benefit for participants who:
  – Attain age 55; and
  – Performed 20 years of service
• No participant is over age 55 nor worked 20 years
• Sponsor wants to eliminate early-retirement benefit as of December 31, 2017
• Eliminating an optional form of benefit?
Early Retirement Benefits (Continued)

- Yes, protected benefit
- But only for accrued benefit as of December 31, 2017
- Participant who is age 30 with five years of service would still be able to elect early retirement
- But the early retirement benefit will be based on accrued benefit as of December 31, 2017

  Treas. Reg. § 1.411(d)-3(g)(6)(i)

- Generally does not apply to early retirement windows
- Created for limited time without subsequent amendment to eliminate

  Rev. Rul. 92-66
DB Subsidized Early Retirement

- DB plan offers subsidized early retirement benefit for participants who:
  - Attain age 55; and
  - Performed 20 years of service
- Participant terminates in 2016 at age 50 with 25 years of service
- Plan amended to eliminate subsidized early retirement benefit as of December 31, 2017
- Terminated participant eligible for benefit at age 55?
- Eliminating an optional form of benefit?
DB Subsidized Early Retirement (Continued)

• Yes, protected benefit
• Terminated participants can “grow” into early retirement benefits
• Cannot require continued employment to be considered protected benefit

Alcantara v. Bakery & Confectionery Union & Industry International Pension Fund Pension Plan, 751 F.3d 71 (2nd Cir. 2014)
DC Distribution Options

• Vendor change for an existing 401(k) plan
• Plan provides QJSA and other annuity options
• No MPPP nor DB assets
• Do you have to deal with notice and consent requirements?
Poll #7: DC Distribution Options

Eliminating an optional form of benefit by removing some of the distribution options?

A. Yes
B. No
C. Maybe
D. Don’t Know
DC Distribution Options (Continued)

- Exception to anti-cutback rules!
- DC may eliminate annuity options for accrued benefits

IRC § 411(d)(6)(E);
Treas. Reg. § 1.411(d)-4, Q&A 2(e)

- No need to provide notice to participants before effective date

ERISA § 204(h)(1);
Treas. Reg. § 54.4980F-1, Q&A 3(a)
ESOP Distribution Options

• Presenting at an enrollment meeting
• Employee wants to roll money into plan from an ESOP
• She received a notice from ESOP sponsor that lump-sum distributions no longer permitted
• She is upset because she wants all retirement funds in one place
• Eliminating an optional form of benefit?
ESOP Distribution Options (Continued)

• Exception to anti-cutback rules!
• Applies when ESOP subject to put option requirement
• ESOP may modify distribution options for accrued benefits
• Also may modify distribution timing

IRC § 411(d)(6)(C);
Treas. Reg. § 1.411(d)-4, Q&A 2(d)
In-Service Distributions

- Client buys another company with existing plan
- Client wants to merge plans
- Acquired plan allows PS account to be distributed after five years participation or contribution in plan at least two years
- Client’s plan only allows in-service upon normal retirement age (65)
- Eliminate acquired plan’s in-service distribution option for pre-merger account balances?
Poll #8: In-Service Distributions

Eliminating an optional form of benefit by removing in-service distribution option?

A. Yes
B. No
C. Maybe
D. Don’t Know
In-Service Distributions (Continued)

- Yes, protected benefit
- Optional form of benefit includes distribution alternatives for accrued benefits
- PS assets acquired must still be permitted in-service after five years participation or two years after contribution
- Future PS contributions to client plan for acquired employees may only permit in-service upon NRA

Treas. Reg. § 1.411(d)-3(g)(6)(ii)
Protected Earnings?

- Are earnings also entitled to protection under anti-cutback rules?
- Just account balance at time of merger permitted in-service after five years participation or two years after contribution?
- Or account balance at time of merger PLUS future earnings?
- Protection of eliminated in-service distribution option may be limited to account balance at the time of merger
- Depends on R/K system
Hardship Withdrawals

• Client buys another company with existing plan
• Client wants to merge plans
• Acquired plan allows hardship distributions
• Client plan does not and does not want to start
• Eliminate acquired plan’s ability to take hardship distributions on pre-merger account balances?
• Eliminating an optional form of benefit?
Hardship Withdrawals (Continued)

• Exception to anti-cutback rules!
• May eliminate hardship-distribution option
• Different than inability to eliminate other in-service distributions
• Sponsor can also limit hardship availability
  – Purchase principal residence
  – Medical expenses
  – Education expenses
  – Etc.

Treas. Reg. § 1.411(d)-4, Q&A 2(b)(2)(x)
Mandatory Cash-Outs

- Plan document requires cash-outs if less than $1,000
- Client wants to reduce administrative costs
- Can cash-out limit be raised to $5,000 (with rollover to IRA)?
Poll #9: Mandatory Cash-out

Eliminating an optional form of benefit by increasing mandatory cash-out amount?

A. Yes
B. No
C. Maybe
D. Don’t Know
Mandatory Cash-Outs (Continued)

- Exception to anti-cutback rules!
- Cash-out threshold permissible under statutory law
- Sponsor may increase cash-out from $1,000 to $5,000 without violating anti-cutback rules

Treas. Reg. § 1.411(d)-4, Q&A 2(b)(2)(v)
Correcting Errors

• Calculation error results in participants receiving allocations or accruals above amount stated in plan or authorized by plan sponsor
• Error found two years later
• Can accrued benefit or account balance be reduced?
• Decreasing an accrued benefit?
Correcting Errors (Continued)

- Not a protected benefit
- Incorrect accrual or allocation is not an accrual of benefits subject to protection
- Participant not entitled to benefit
- Corrections including reductions in accrued benefit or account balance permitted

Rev. Proc. 2016-51, Appendix B
Ancillary Benefits

• Not protected benefits:
  – Ancillary life-insurance protection
  – Accident or health-insurance benefits
  – Most social security supplements
  – Availability of loans
  – Right to make after-tax employee contributions or elective deferrals

Treas. Reg. § 1.411(d)-4, Q&A 1(d)
Ancillary Benefits (Continued)

• Not protected benefits:
  – Right to direct investments
  – Right to a particular form of investment
  – Allocation dates or time for contributions and valuation dates for account balances
  – Administrative procedures for distributions
  – Rights that derive from administrative and operational provisions (allocating earnings in DC account)

Treas. Reg. § 1.411(d)-4, Q&A 1(d)
Ancillary Benefits (Continued)

• May be eliminated from the plan
  – Participant loan features
  – Self-directed brokerage accounts
  – Ability to purchase life insurance
    • Force liquidation of existing insurance contracts unless participants agree to purchase outside of plan

Treas. Reg. § 1.411(d)-3(b)(3)(i)

DOL PTE 92-6
Plan Eligibility

- Plan allows employees to participate immediately
- Employee hired June 18, 2017 began to defer salary to 401(k) plan on July 1, 2017
- Sponsor has come to you to save administrative expenses
- You recommend one year of service eligibility due to turnover of workforce
- Sponsor agrees and wants to amend the plan immediately to require one year of service
- Is employee above prevented from continuing to defer until completion?
Poll #10: Plan Eligibility

Decreasing an accrued benefit by employee no longer being eligible for the plan until new condition satisfied?

A. Yes
B. No
C. Maybe
D. Don’t Know
Plan Eligibility (Continued)

- Not protected benefit
- Accrued benefit (deferrals) remain in plan
- Only impacts future accruals
- Ability to defer is an ancillary benefit
- Sponsor could, but not required to, make new eligibility conditions applicable to only employees hired after amendment

Treas. Reg. § 1.411(d)-4, Q&A 1(d)
Summary

1) Decreasing an accrued benefit
   • Accrual or allocation formula
   • Cost of living adjustments
   • Allocation conditions
   • May reduce future benefits
   • Cash balance wear-away
   • Correcting errors
   • Ancillary benefits not protected
Summary (Continued)

2) Eliminating an optional form of benefit
   • Distribution timing
   • Distribution options (actuarial assumptions and early-retirement benefits)
     – Except DB redundant or noncore options
     – Except DC annuity options
     – Except ESOP distribution options
     – Except hardships
     – Except mandatory cash-outs
Questions?