0001 [ST: 113] [ED: 100000] [REL: 2] (Beg Group) **Composed:** Mon Aug 22 13:22:17 EDT 2011
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Chapter 6

ACCRUED BENEFIT REQUIREMENTS

General Topics:	Accrued Benefit Requirements
ERISA:	§§ 201 and 204
Regulations:	Labor Reg. §§ 2530.200(b)-2 and (b)-3; and 2530.204
	Skim Treas. Reg. §§ 1.401(a)(17)-1; 1.410(a)-7; 1.411(a)-4 and B7, 1.411(b)-1, 1.411(c)-1; 1.414(s)-1; 1.415-2(d); and 1.416-1, M-2, M-4, M-7, and M-10
	Read Prop. Treas. Reg. § 1.411(d)-3. See changes made by EGTRRA '01 to the compensation limitation of Code § 401(a)(17)
Internal Revenue Code:	§§ 401(a)(17) and (25); 411(a)(7), 411(b) and (c); and 414(i), (j) and (s)
Additional References:	I.R.S. Alert Guidelines B Minimum Vesting Standards for Defined Benefit Plans Worksheet and Explanation at http://www.irs.gov/pub/irstege/d6390.pdf (May 24, 2005)
	Hollingshead v. Buford Equip. Co., 747 F. Supp. 1421 (M.D. Ala. 1990), *reconsidered*, 809 F. Supp. 906 n.10 (M.D. Ala. 1992)
	Jones v. UOP, 16 F.3d 141 (7th Cir.), *reh'g denied* (en banc), 1994 U.S. App. LEXIS 3450 (7th Cir. 1994)

§ 6.01 OVERVIEW OF CODE § 411(a)

During the 1960s and 1970s, most retirement plans were designed as defined benefit plans, intending to provide a given stream of replacement income to the employee/spouse if and when the employee finally retired. From the employer's perspective, those employees who terminated employment at the plan's retirement age were eligible for these retirement benefits; however, employees who terminated employment prior to retirement were generally not retirees under these plans and thus did not accrue a benefit during employment. Obviously the employee was in danger of being terminated from employment prior to the plan's normal retirement age so that the employer could forego any retirement payments.

In contrast, multiemployer plans were not tied to retirement from a specific employer. These plans generally provided a given defined benefit for a union employee as a result of his/her employment with a variety of participating employers over the course of his/her career, regardless of whether the employee was employed by a particular employer at the plan's retirement age. Such benefits

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were generally of the unit credit type (a fixed percentage of current compensation for each year of service), granting additional benefits to a retiree based on his/her seniority. In contrast, single employer plans could provide a retirement formula based on a fixed percentage of final average earnings (FAE) (*e.g.*, 50% of final average pay at retirement) in lieu of a unit credit formula. If the employee spent his/her career with the single employer, the fixed percentage formula was easy to administer and reflected a suitable level of retirement that the employer was willing to contract for.

Defined contribution plans provided a given allocation formula that would define the participant's benefit for the current year. A common formula prescribed the same fixed percentage for all participants in a given plan year (*e.g.*, 10% of pay). A defined contribution allocation formula based on age or service was permitted but could be discriminatory if the highly paid were older or had greater service.[1]

ERISA established the concept of an "accrued benefit" to work in harmony with its vesting standards. Employees who had otherwise satisfied the plan's eligibility requirements would be eligible to receive retirement benefits from the plan, even if they terminated employment prior to the plan's retirement age. Defined contribution plans were required to ascribe a fixed allocation rate for all eligible participants in a given plan year, and the vesting standards were designed to protect such benefits if the participant participated for a minimal number of years. The two requirements were easy to understand and to formulate. However, in the context of defined benefit plans, Congress affirmed the employer's ability to formulate the accrued benefit formula, just as it specified the normal retirement formula. Given that the choice remained with the employer (as in the case of coverage), specific tests were imposed under the Code to assure nondiscrimination in favor of the highly paid (who were assumed to have the maximum years of participation and to be of older age).

In the previous chapter, the vesting rules of ERISA and the Code were discussed. Such rules were designed to protect a participant's accrued benefit from forfeiture in the event the participant terminated employment prior to retirement and to guarantee the delivery of the plan's normal retirement benefits to the participant upon attainment of the normal retirement age. As such, in the defined benefit context, the drafters of ERISA and the Code were very much concerned about the employer's design of the plan's accrued benefit formula. If the accrued benefit formula resulted in very minimal accruals during the years of vesting (saving the larger accruals for the later years of employment), such formulation would certainly circumvent the vesting standards imposed by ERISA and the Code. As a result, ERISA and the Code prescribe accrued benefit standards for defined benefit plans to prevent this phenomenon, collectively called "backloading" (*i.e.*, providing a greater level of accruals in the later year as opposed to the early years of participation). In contrast, such requirements are not necessary for a defined contribution plan as the participant accrues whatever is allocated to his/her account balance for the current year.

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[1] *See* Rev. Rul. 81-202, 1981-2 C.B. 93, 1981-2 C.B. 93, made obsolete by Rev. Rul. 93-87, 1993-2 C.B. 125, permitting different plans to be aggregated for coverage testing purposes if the plans were "comparable" in benefits or contributions.

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The concepts of "accrual rate" and "accrued benefit" become confusing in the cash balance context where an employer is utilizing a defined benefit plan to provide benefits, but relying on the defined contribution principles to explain such benefits.

§ 6.02 DEFINITION OF ACCRUED BENEFIT

ERISA and the Code define a participant's accrued benefit as follows:[2]

- in the case of a defined benefit plan, the employee's accrued benefit is to be determined under the plan and expressed in the form of an annual benefit commencing at normal retirement date (if the plan defines accrued benefit in this manner); and
- in the case of any other plan, the employee's accrued benefit is the balance in the employee's account.

An accrual rate is different from the accrued benefit, as the former represents the annual rate at which a participant accrues the plan's normal retirement benefit and must satisfy one of the statutory minimum accrual requirements. Generally, one must refer to the plan's accrued benefit formula to ascertain each year's accrual rate. In contrast, a participant's accrued benefit under a defined benefit plan represents the cumulative value of those accruals, to be valued at the plan's retirement age and expressed as an annuity benefit at that age. For a defined contribution plan, a participant's accrued benefit represents the cumulative value of allocations made to his/her account balance, plus interest and/or capital gains or losses. For a defined benefit plan, the employer is free to use a fixed level to determine the normal retirement benefit formula (*e.g.*, 60%× final average earnings (FAE)), but the accrued benefit is inherently a unit-type formula as the participant generally accrues a benefit for each year of participation (*e.g.*, 2% × FAE × years of service).

Accrued benefits should be contrasted with vesting. An employee's accrued benefit describes his/her benefit under the plan, whereas vesting describes how much of that benefit is nonforfeitable. There is no absolute requirement that an employee accrue a benefit for the plan year, or that the employer make a contribution each plan year.[3]

Since an accrued benefit is a promise to pay an annuity at retirement, the present value of such benefit must be discounted for interest and mortality. Sometimes the interest and mortality assumptions differ pre-retirement versus post-retirement.

> **Example:** Paula Participant is entitled to a pension of $10,000 per year beginning at age 65. Using a 5% post-retirement and the 1983-IAM-M mortality table, the value of that annuity at age 65 is $114,600. What this means is that $114,600 must be available when Paula attains age 65 if annuity payments of $10,000 per year can be made. If Paula was currently age 45 and entitled to an accrued benefit of $10,000 per year beginning at age 65, the present value of that benefit (using pre-retirement interest rate

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[2] I.R.C. § 411(a)(7).

[3] Rev. Rul. 76-250, 1976-2 C.B. 124.

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of 6%, but continuing the 1983-IAM-M mortality table) is $35,732. Thus, if Paula were to terminate employment and elect a lump sum payment, the plan would pay $35,732.

§ 6.03 THE ACCRUAL COMPUTATION PERIOD

An employee generally accrues a benefit based upon participation in the plan and the crediting of one or more years of participation. A year of participation is measured by counting an employee's hours of service during a specified 12-consecutive month period when the employee becomes a participant under the plan.

For employers unwilling or unable to count hours of service for computation purposes, the regulations provide as an alternative the elapsed time method of computation.[4] Although benefits generally are earned only while the employee is a participant under the plan, the employer may credit benefits based on service rendered prior to the effective date of the plan. Such benefits are then granted as "past service" benefits. Likewise, an employer adopting an increased benefit formula through a plan amendment may increase prior participation years with the increased formula, thereby granting a "past service" benefit.

Generally all years of participation must be counted for benefit accrual purposes, except that years with respect to which the employee has received a distribution of benefits may be disregarded unless the employee returns to service and repays the earlier distribution.[5] A plan may designate any 12- consecutive month period as the accrual computation period, but that period so designated must apply equally to all participants.[6] This does not mean, however, that each employee accrues a benefit based on the same 12-month period. For example, the accrual computation period may be designated as the 12-consecutive month period commencing on either of two semiannual entry dates for participation purposes.[7]

If the plan's eligibility computation period is not the same 12-month consecutive period as used for benefit accrual purposes, and the participant is admitted to participate or the participation begins during the plan year (as opposed to the beginning of the plan year), retroactive credit for all hours of service since the beginning of the applicable plan year must be given.[8]

Likewise, former employees who must satisfy a one-year participation holdout provision in order to be given retroactive admission must be granted retroactive benefit accrual credit during the hold-out period if they are readmitted.[9] A year of participation means a period of service that is calculated on a reasonable and consistent basis and generally includes all of the employee's service from the

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[4] Labor Reg. § 2530.204-3(a). Under the elapsed time method, an employee is credited with his or her total period of service with the employer, irrespective of the actual hours of service worked.

[5] I.R.C. § 411(a)(7)(B).

[6] Labor Reg. § 2530.204-2(a).

[7] *Id.*

[8] I.R.C. § 410(a)(3)(A).

[9] Labor Reg. § 2530.204-2(c)(3).

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earliest date of participation.[10] A plan may require an employee to earn 1,000 hours of service during the accrual computation period in order to be credited with participation.[11] Consequently, an employee must be credited with at least a partial year of participation if he/she earns at least 1,000 hours of service. A plan may require more than 1,000 hours of service to earn a full year of participation, but then must credit the employee with a partial year of participation if he/she earns at least 1,000 hours of service.[12]

Example: a plan may require 2,000 hours of service to earn a full year of participation and may credit a partial year based on the following schedule:[13]

Hours of Service	Percentage of Full Year
1,000	50
1,001– 1,200	60
1,201– 1,400	70
1,401 – 1,600	80
1,601 – 1,800	90
1,801 – 2,000	100

Virtually all nonunion plans credit a full year of participation for 1,000 hours of service. Many union plans require more than 1,000 hours of service for a full year of participation.

Consistent with the rules applicable for eligibility and vesting, an employee must be credited with all hours of service for each:

- hour for which he/she is directly or indirectly paid for the performance of services for the employer (“hours worked”);
- hour for which he/she is directly or indirectly paid for periods in which no services are performed due to vacation, holiday, illness, incapacity, payoff, jury duty, military duty or authorized leave of absence;[14] and
- hour of back pay awarded or agreed to by the employer (and credited in the year to which the back pay relates vs. paid).[15]

Note that double counting of hours is prohibited.

Department of Labor regulations permit crediting of service based on regular time hours, periods of employment, or earnings.[16] A plan may credit employees under a system whereby 750 regular time hours are treated as the equivalent of 1,000 hours of service and 375 regular time hours are treated as equivalent to 500

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[10] I.R.C. § 411(b)(4)(A).

[11] I.R.C. § 410(b)(4)(C).

[12] Labor Reg. § 2530.204(c).

[13] *See* Labor Reg. § 2530.204(c)(4)(ii).

[14] Labor Reg. § 2530.200b-2(a)(2).

[15] *Id.*

[16] Labor Reg. § 2530.200(b)-3.

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hours of service.[17] "Regular time hours" are defined as hours worked (defined above) and hours for which back pay is awarded or agreed, to the extent such award or agreement relates to a period during which the employee would have worked.

A plan may determine the number of hours of service to be credited to employees on the following basis:

- Using days of employment, if an employee is credited with 10 hours of service for each day for which the employee would have been credited with at least one hour of service;
- Using weeks of employment, if an employee is credited with 45 hours of service for each week for which the employee would have been credited with at least one hour of service;
- Using semi-monthly payroll periods, if an employee is credited with 95 hours of service for each semi-monthly payroll period the employee would have been credited with at least one hour of service;
- Using months of employment, if an employee is credited with 190 hours of service for each month for which the employee would have been credited with at least one hour of service;
- Using earnings, if an employee is compensated on an hourly basis, by crediting the number of hours equal to the total earnings during the computation period divided by the employee's lowest hourly rate (or lowest hourly rate of similarly situated employees) during the period. For hourly employees under this election, 870 hours are treated as equivalent to 1,000 hours of service and 435 hours are treated as equivalent to 500 hours of service. In the case of an employee who is compensated on other than an hourly basis, the employee is credited with the same number of hours as above but 750 hours are treated as equivalent to 1,000 hours of service and 375 hours are treated as equivalent to 500 hours of service.[18]

An alternative method of computing an employee's service is by reference to his/her entire period of employment. Computation periods are not necessary under the elapsed time method.[19] The elapsed time method may be used for purposes of participation, vesting and benefit accrual purposes.[20] The elapsed time method is used by employers to avoid the administrative burden of counting hours.

An employee's period of service for benefit accrual purposes commences when he/she commences participation under the plan.[21] His/her period of service ends when he/she severs from service.[22] An employee's severance from service is the earlier of:

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[17] Labor Reg. § 2530.200(b)-3(d)(2).

[18] *See* Treas. Reg. § 1.410(a)-7(a)(3).

[19] Treas. Reg. § 1.410(a)-7(a).

[20] Treas. Reg. § 1.410(a)-7(a)(1).

[21] Treas. Reg. § 1.410(a)-7(b)(2).

[22] Treas. Reg. §§ 1.410(a)-7(a)(2)(iv), -7(a)(3)(iv) and -7(e)(1).

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- the date he/she quits, retires, is discharged or dies; or
- the first anniversary of the first date of a period in which he/she remains absent from service (with or without pay) for any reason other than the ones mentioned above.[23]

The regulations provide special rules for determining an employee's severance of service due to maternity/paternity leave and for military leave.[24] Periods of severance, even if less than 12 months, can be disregarded for benefit accrual purposes.[25] Nonsuccessive periods of participation must generally be aggregated.[26]

§ 6.04 ACCRUED BENEFITS UNDER A DEFINED CONTRIBUTION PLAN

An employee's accrued benefit under a defined contribution plan is simply the balance in his/her account. A defined contribution plan must separately account for each employee's accrued benefit.[27] A plan is not required to separately account for employer contributions and employee contributions under the same plan.[28]

As a practical matter, most if not all plans maintain separate accounts for both employer and employee contributions and separately allocate income, gains and losses between both accounts. If the plan does not separately account for employer contributions, the portion of an employee's account balance derived from his/her own contributions is determined by multiplying the account balance by a fraction, the numerator of which is the aggregate employee contributions (less withdrawals) and the denominator of which is the sum of the employer's and employee's contributions (both less withdrawals). The numerator and denominator of the fraction exclude income, gain and losses earned on the contributions.[29]

An employee accrues a benefit for a computation period (generally the plan year) if his/her account is credited with an allocation of employer contributions (including forfeitures) or with employee contributions for that year. Whether an employee accrues a benefit for a plan year generally has no impact on whether he/she accrues a benefit for any other plan year.

An employer may condition the allocation of an employer contribution upon the participant's attainment of a minimum number of hours of service during the plan year, generally 1,000 hours. A plan does not have to unconditionally allocate a contribution for a plan year in which the employee fails to earn 1,000 hours of service provided the denial does not discriminate in favor of highly compensated employees.[30] For example, a plan may require the employee to earn 1,000 hours of

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[23] Treas. Reg. § 1.401(a)-7(b)(2).

[24] *See* Treas. Reg. § 1.410(a)-9.

[25] Treas. Reg. § 1.410(a)-7(e)(1).

[26] Treas. Reg. § 1.410(a)-7(b)(6)(ii).

[27] I.R.C. § 411(b)(3)(B).

[28] T.I.R. 1344 (January 8, 1975), Q&A V-10.

[29] I.R.C. § 411(3)(B).

[30] I.R.C. § 411(b)(1)(E); Treas. Reg. § 1.411(b)-1(d)(1).

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service and be employed on the last day of the plan year in order to receive an allocation for the plan year. This last day employment requirement is generally referred to as an "active participant rule" and is closely scrutinized by the Service.

Generally the level of annual allocations under a defined contribution plan is based on the participant's present compensation, and therefore unrelated to the participant's age. Such allocations present no accrued benefit problems.

However, the Code prohibits the annual allocations to an employee's account from ceasing or the rate of allocation from being reduced based on the attainment of any age.[31]

Such prohibition is required to be reconciled with the Code's nondiscrimination, coverage, and maximum limitations provisions.[32] Under the final regulations relating to coverage and nondiscrimination, the Service affirmed the use of age-weighted allocation formulas for defined contribution plans, consistent with the nondiscrimination standard of the Code.[33] Such age-weighted formulas increase the rate of allocation on account of age rather than reduce the annual rate of allocation. In the context of target benefit plans, Congress has authorized the Service to prescribe regulations consistent with its intent regarding all defined contribution plans.[34]

A question arises as to whether the employer may amend the plan's allocation formula after the end of the plan year, applicable for current plan year allocations. In a Technical Advice Memorandum, the Service held that a plan amendment changing the discretionary profit sharing plan's allocation formula after the end of the plan year but before the due date of filing the employer's tax return violated the anti-cutback rule.[35] Its reasoning was that Code § 411(d)(6) extended not only to the amounts credited in the participants' account as of the valuation date, but also to amounts a participant would have been entitled to even though no contributions had yet been made. The regulations also extend this reasoning to changes in a plan's forfeiture provisions after the end of the plan year.[36]

Another question arises as to whether the employer may amend the plan's valuation date retroactively for all terminated participants in a given plan year. A defined contribution plan's account balances must be valued at least annually, but some plans value quarterly, monthly or even daily, especially if the participants are directing investment choices. The regulations do not consider the plan's valuation date as a protected benefit,[37] but some courts have held that changes in valuation

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[31] I.R.C. § 411(b)(2)(A).

[32] I.R.C. § 411(b)(2)(C).

[33] Treas. Reg. § 1.410(a)(4)-2(b)(3).

[34] I.R.C. § 411(b)(2)(B).

[35] Tech. Adv. Mem. 9735001.

[36] Treas. Reg. § 1.411(a)-8. According to the Service, once the conditions for receiving an allocation of contributions or forfeitures for a given plan year have been satisfied, I.R.C. § 411(d) protection applies to the plan's allocation formula.

[37] I.R.C. § 411(a)(7)(A).

dates may constitute a breach of fiduciary duty.[38]

From a business point of view, employers of defined contribution plans should consider using the valuation date occurring on or after the participant's termination of employment for purposes of valuing his/her account balance. Plans using a prior valuation date allow the participant the benefit of 20/20 hindsight (especially in light of plan losses) to avoid losses and to seek gains to the detriment of the other plan participants. If the plan sponsor alters the valuation date from a prior valuation date to a subsequent valuation date for participants who have terminated employment during the interim, a potential cut-back issue may arise. The sponsor's motivation for such change is to have the terminated participants share in the plan losses equally with the active participants.

Where there has been a decline in the value of plan assets and the employer adopts a plan amendment changing the valuation date that affects participants who terminate employment after the change, the Tenth Circuit has held that the valuation date with respect to the terminated participants could not be changed after their termination.[39] The issue of valuation date becomes less controversial as plans move to daily valuation dates.

§ 6.05 ACCRUED BENEFITS UNDER A DEFINED BENEFIT PLAN

For participants who do not retire with the employer, but terminate employment and subsequently attain the plan's retirement age, a defined benefit plan must provide for a portion of the ultimate normal retirement benefit that has been accrued over his/her years of plan participation.[40] Such formula is referred to as the "accrued benefit formula" and must be described as an annual benefit commencing at the plan's normal retirement age, or the actuarial equivalent of such a benefit.[41]

> **Example:** Assume a defined benefit plan provides for a normal retirement benefit and accrued benefit of 1% of final average earnings (highest three year average of compensation) times years of participation. Paul Participant (unmarried) began participating at age 35 and is now age 55 and the plan's normal retirement age is 65. Paul's average compensation over the last three years is $50,000. Paul's accrued benefit = 1% × $50,000 × 20 years = $10,000/year/65/life only. Note: if Paul continues to be a participant in the plan and his final average earnings increase to $60,000 by age 65, Paul's accrued benefit for those years from age 35 to 55 is retroactively increased to 1% × $60,000 × 20 years = $12,000/yr/65/life only.

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[38] *See* Pratt v. Maurice L. Brown Employee Savings Plan, 9 E.B.C. 2380 (D.C. Kan. 1988), *aff'd sub nom.* Pratt v. Petroleum Production Management, Inc. Savings Plan & Trust, 920 F.2d 651 (10th Cir. 1990). *But see* Holian v. Leavitt Tube Co., Inc., 1989 U.S. Dist. LEXIS 4584 (N.D. Ill. 1989); Cator v. Herrgott & Wilson, Inc., 609 F. Supp. 12 (N.D. Cal. 1985).

[39] I.R.C. § 411(c)(3).

[40] Treas. Reg. § 1.411(b)-1(a). *See generally Pratt*, 920 F.2d 651.

[41] I.R.C. § 411(c)(3). To satisfy the definitely determinable requirement, such actuarial assumptions must be determined in a manner that precludes employer discretion. *See* I.R.C. § 401(a)(25).

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If a defined benefit plan determines an employee's accrued benefit in a form other than an annual benefit commencing at normal retirement date, then accrued benefit means the actuarial equivalent of the accrued benefit determined under the plan.[42] Normal retirement age is defined as the earlier of (1) the age specified in the plan or (2) age 65 or the fifth anniversary of plan participation.[43] A plan may delay credit of the accrued benefit of an employee until the employee completes two continuous years of service (used for participation purposes).[44]

In general, the term accrued benefit refers exclusively to pension or retirement benefits. Ancillary benefits such as medical expenses (or premiums for such expenses), disability benefits not in excess of employee's normal retirement benefit, life insurance benefits, incidental death benefits, or the current portion of life insurance protection are not considered part of an employee's accrued benefit.[45] However, optional forms of benefits (*e.g.* lump sum payment, distribution in-kind) are considered accrued benefits for some purposes.

An employee's accrued benefit derived from his/her own contributions is the employee's aggregate contributions (less withdrawals) expressed as an annual benefit commencing at normal retirement date, using an interest rate determined under Code § 417(e).[46] As a practical matter, very few defined benefit plans permit employee contributions.

The determination of an employee's accrued benefit must satisfy one of three alternative tests found in Code § 411(b)(1):

- the 3% method;
- the 133⅓% rule; or
- the fractional rule.

The purpose of these rules is to test the annual accrual rate in terms of how fast or slow an employee is accruing the ultimate normal retirement benefit. Normally an employer will not design the accrual rate to be front-loaded (*i.e.*, provide greater accruals in the early years of participation) as such formula does not reward seniority. However, an employer may be tempted to back-load the formula (*i.e.*, provide greater accruals in the later years of participation). The goal of the Code § 411(b) tests is to prevent excessive backloading. Excessive backloading is a technique used to accrue minimal benefits in the early years of participation and richer benefits in the later years of participation. If allowed, the accrued benefit formula could be used to circumvent the vesting schedule limitations.

A plan may determine an employee's accrued benefit under more than one benefit formula; however, the accrued benefits under all such formulas used must be aggregated to determine whether the plan satisfies one of the alternative tests.[47]

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[42] I.R.C. § 411(c)(3).

[43] I.R.C. § 411(a)(8).

[44] I.R.C. § 411(b)(1)(E); Treas. Reg. § 1.411(b)-1(d)(1).

[45] Treas. Reg. § 1.411(a)-7(a)(1); I.R.C § 411(d)(6)(B)(ii).

[46] I.R.C. § 411(c)(2)(B).

[47] Treas. Reg. § 1.411(b)-1(a)(1).

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Moreover, a plan may use a different alternative test for different classes of employees under the plan provided such classes are not structured to evade Code § 411(b)(1).[48]

Consistent with these rules, the Code also prohibits the accrued benefit from decreasing on account of age or service.[49] However, a plan may limit the number of years of service that may be taken into account for determining the amount of, or the rate at which, benefits accrue under the accrued benefit formula.[50]

Caveat: The rules of Code § 411(b) are testing the rate at which the participant's accrued benefit is changing over his/her years of participation. Thus, defined benefit plans using final average earnings (usually abbreviated FAE), as opposed to career average earnings (usually abbreviated AAC for Average Annual Compensation), as the basis for the accrued benefit and normal retirement benefit formulas are inherently providing richer accruals in all years of participation as compensation is increasing. Such increase in compensation is not what is being tested under Code § 411(b).

Example: NRB = AB = 2 × FAE × years of participation/65/life only or J&S. The rate of accrual under the plan's accrued benefit is uniform in all years of participation and thus is not backloaded even though the participant's compensation happens to increase and the actual value of the later years' accrued benefits is greater than the earlier years' accrued benefits.

[A] The 3% Method

The plan's accrued benefit formula satisfies the 3% method if a participant's accrued benefit on any given date is not less than 3% of the normal retirement benefit (determined as if he/she commenced participation at the earliest possible entry age and continued participation until age 65 (or, if earlier, the plan's normal retirement age)) multiplied by his/her actual years of participation in the plan, not to exceed 33⅓ years.[51] In other words, a plan which provides an equal accrual rate (regardless of seniority) whose NRB can be attained within 33⅓ years or less will satisfy the 3% rule.

Example 1:[52] A plan provides a normal retirement benefit and accrued benefit, commencing at age 65, of $48/month × years of participation. Participation can begin as early as age 21. This plan's accrued benefit formula fails the 3% method. The theoretical maximum NRB = [$2,112/month (*i.e.*, $48/month × (65-21)]/65/life only or J&S. Under the 3% method, the plan's accrued benefit must provide a minimum monthly accrued benefit each year of at least 3% × $2,112 = $63.36/month. Since

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[48] *Id.*

[49] I.R.C. § 411(b)(1)(G). However, reductions due to Social Security benefits or the commencement of Social Security benefits are not to be considered. *See also* I.R.C. § 411(b)(2).

[50] Prop. Treas. Reg. § 1.411(b)-2(c)(2)(i).

[51] I.R.C. § 411(b)(1)(A).

[52] *See* Treas. Reg. § 1.411(b)-1(b)(1)(iii) Example (1).

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$63.36/month is greater than $48/month under the plan's accrued benefit formula, the plan fails the 3% method. Note: the plan could have satisfied the 3% Rule had the normal retirement benefit and accrued benefit formulas been capped at 33⅓ years of service.

Example 2:[53] A plan provides a normal retirement benefit, commencing at age 65, of 60% of FAE, for participants with 30 years of service. The plan's accrued benefit formula is 2% × FAE × years of participation (capped at 30 years). There is no minimum age or service requirement for eligibility. The plan's accrued benefit formula satisfies the 3% method. The theoretical maximum NRB is 60% of FAE. Hence, the minimum annual accrual must be 3% H (60% × FAE/65/life only or J&S), which is an annual accrual rate of 1.8%. Since the plan's annual accrual rate is 2%, it exceeds the minimum rate of 1.8% and thus satisfies the 3% method.

If the normal retirement benefit is based upon compensation, an employee's normal retirement benefit is determined as if the employee continued to earn annually the average rate of compensation that he/she earned during the number of consecutive years of participation (not to exceed 10 years) in which he/she earned his/her highest compensation.[54] Accordingly, plans that use career average compensation cannot rely on the 3% method, as compensation used to compute accrued benefits could exceed 10 years' worth of participation. Social Security benefits and all relevant factors (such as the consumer price index) are treated as remaining constant for future years until normal retirement date.[55]

[B] The 133⅓% Rule

This second rule was designed for plans in which the accrued benefit formula provides different accrual rates for earlier versus later years of participation (referred to as step-rate plans). An employee's accrued benefit satisfies the 133⅓% rule if the different annual rates applied to the normal retirement benefit are compared to one another and the annual rate at which an employee can accrue a benefit for any later year is not more than 133⅓% of the annual rate at which benefits can accrue for any earlier plan year. Put another way, for any given year, the accrual rate for that year must be compared with the accrual rate in any later year to determine whether the accrual rate in the later year exceeds 133⅓% of the accrual rate in the earlier year.[56]

Example: A plan provides an accrued benefit = 2⅓%× compensation × years of participation (for each of the first 10 years) + 3% × compensation × years of participation (for each of the next 10 years) + 4% × compensation × years of participation (for each of the next 10 years, 30 years cap). Such accrued benefit formula does not satisfy the 133⅓% rule

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[53] *See* Treas. Reg. § 1.411(b)-1(b)(1)(iii) Example (3).

[54] *Id.*

[55] *Id.*

[56] I.R.C. § 411(b)(1)(B).

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because the percent increase from 2⅓% to 4% is 172%, which exceeds 133⅓%. Note: always compare the accrual rate from the lowest to the highest when testing under this rule.

[C] The Fractional Rule

Under the fractional rule, an employee's accrued benefit is defined in terms of an annual rate applied to the plan's NRB, and that rate is determined by a fraction (not to exceed one), the numerator of which is the employee's years of participation under the plan and the denominator of which is the number of years of participation the employee would earn if he/she worked until normal retirement date. Since the fractional rule accrues a participant's normal retirement benefit ratably over his/her total years of participation, it penalizes younger hires and favors older hires. Such formula is definitely less expensive for an employer with younger hires and more expensive for an employer with older hires. Any amendment to the plan for the current plan year is treated as in effect for all other plan years.[57] Any change in an accrual rate that does not apply to any employee who could participate in the plan is disregarded.[58] The fact that certain benefits may be payable to certain employees before normal retirement date is disregarded.[59] Social Security benefits and all other relevant factors are treated as remaining constant for all future years.[60]

Example:[61] A plan provides a normal retirement benefit, commencing at age 65, equal to 30% of an employee's FAE (highest three years average compensation during the last 10 years of participation). Employee is age 55, is credited with 15 years of participation and has FAE of $20,000. This employee's monthly accrued benefit satisfies the fractional rule if his/her monthly accrued benefit is at least equal to $300/month (*i.e.*, 30% × $20,000/12 month × 15/25). Note: for this employee, hired at age 40, the accrued benefit formula assumes that 1/25th of the NRB accrues each year.

The fractional rule benefit is the annual benefit, commencing at normal retirement date, the employee would receive if he/she continued to earn annually the same rate of compensation upon which his/her retirement benefit would be computed.[62] The employee's compensation should be computed on the basis of compensation considered under the plan (but considering average compensation for no more than 10 years preceding the determination).[63] As a result, career averaging plans cannot generally rely on the fractional rule for compliance.

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[57] I.R.C. § 411(b)(1)(B)(i).

[58] I.R.C. § 411(b)(1)(B)(ii). For example, if the plan provided an annual rate of 2% for plan years prior to 1980, but was amended to increase the annual accrual rate to 3% for plan years 1981 and thereafter, the plan does not fail this rule because the prospective change in the accrual rate does not apply to any individual who is or could be a participant in the 1980 plan year.

[59] I.R.C. § 411(b)(1)(B)(iii).

[60] I.R.C. § 411(b)(1)(B)(iv).

[61] *See* Treas. Reg. § 1.411(b)-1(b)(3)(iii) Example (1).

[62] I.R.C. § 411(b)(1)(C).

[63] *Id.*

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§ 6.06 CONTINUED ACCRUAL BEYOND NORMAL RETIREMENT AGE

OBRA '86 added the requirement to defined benefit plans that accruals may not cease nor be reduced in the event that participant remains employed after the normal retirement age and is otherwise eligible for an accrual.[64] Thus, benefits available upon actual retirement must be the greater of the normal retirement benefit using all years of participation (including those after normal retirement age) or the actuarial equivalent of the participant's normal retirement benefit computed as of normal retirement age.

Prior to that change, defined benefit plans were permitted to exclude employees from participation and thus benefit accrual, if they were hired within five years of the plan's normal retirement age.[65] Defined benefit plans were permitted to suspend the payment of retirement benefits after the normal retirement age in the event a retiree is later reemployed or continues in employment with the plan sponsor.[66] However, upon subsequent retirement, benefits are required to be recomputed using years of participation earned after normal retirement age and applicable compensation for such years.[67]

Defined contribution plans are also prohibited from ceasing allocations, or reducing the rate of allocation, to an employee's account simply because the employee has attained a given age.[68]

§ 6.07 SPECIAL RULES USED IN CROSS-TESTING

Code § 401(a)(4) requires that a qualified plan be nondiscriminatory in amount, either as to employer-provided contributions or employer-provided benefits. It is not necessary for both the contributions and benefits provided under the plan to be nondiscriminatory in amount.

A defined contribution plan can be shown to be nondiscriminatory in amount on the basis of contributions allocated annually to employees under the plan.[69] The test of Code § 401(a)(4) may require the actual rates of allocation (as a percentage of compensation) provided to employees be compared and proven nondiscriminatory. A defined benefit plan can be shown to be nondiscriminatory in amount on the basis of benefits provided under the plan.[70] The test of Code § 401(a)(4) may require the actual accrual rates (as a percentage of compensation) provided to employees to be compared and proven to be nondiscriminatory.

Because the coverage rules of Code § 410(b) required aggregation of deferrals under both defined contribution and defined benefit plans, the Service had to

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[64] Pub. L. No. 99-509, § 9202(b)(1)(A)-(B), adding subparagraph (H) to I.R.C. § 411(b)(1).

[65] I.R.C. § 411(b)(2).

[66] ERISA § 203(a)(3)(B).

[67] I.R.C. § 411(b)(1)(H)(iii); Prop. Treas. Reg. § 1.411(b)-2(b)(4).

[68] I.R.C. § 411(b)(2).

[69] Treas. Reg. § 1.401(a)(4)-2.

[70] Treas. Reg. § 1.401(a)(4)-3(a).

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provide cross-testing rules whereby defined contribution allocations could be converted to defined benefit accruals and defined benefit accruals could be converted to defined contribution allocations. The Service used the nondiscrimination rules to set forth how a defined contribution plan can be tested on the basis of benefits (instead of annual contributions allocated) and thus shown to be nondiscriminatory in amount on the basis of equivalent benefits. The regulations prescribe the rules for such a conversion.[71] Generally, the increase in the employee's account balance is converted to a straight life annuity, beginning at the plan's normal retirement age or age 65. Such a benefit can then be expressed as a percentage of the employee's average annual compensation and then compared to other participants' rates of benefit accrual.

Likewise, a defined benefit plan can be tested on the basis of contributions (in lieu of the annual accrued benefits) and thus show that the plan is nondiscriminatory in amount on the basis of equivalent allocations.[72] This is a complicated process. Simply stated, the increase in the employee's accrued benefit for the year is expressed as an annual annuity, and then, by means of reasonable actuarial assumptions, is converted to a current allocation amount that is the basis for testing. Defined contribution plans relying on the cross testing rules must satisfy a minimum allocation gateway test or provide broadly available allocation rates.[73]

§ 6.08 TOP HEAVY MINIMUM ACCRUAL OF BENEFITS

Code § 416(c)(2) provides that each employee who is not a key employee (as defined under Code § 416(i)(1)) must accrue a minimum contribution during each plan year in which the plan is top-heavy equal to the lesser of:

- 3% of his/her compensation; or
- the maximum contribution accrued by any key employee.

Each non-key employee who is employed on the last day of a plan year in which the plan is top-heavy is entitled to a top heavy minimum allocation, even if the employee failed to earn 1,000 hours of service during the plan year.[74] EGTRRA '01 provided that all employer contributions, including matching contributions, will count for purposes of satisfying this minimum accrual requirement.[75]

Code § 416(c)(1) provides that each employee who is not a key employee (as defined under Code § 416(i)(1)) must accrue a minimum benefit during each plan year in which the plan is top heavy equal to his/her average compensation (during the 5 year period in which his/her average compensation is the highest) multiplied by the lesser of:

- 2% multiplied by his/her years of vesting service, or

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[71] Treas. Reg. § 1.401(a)(4)-2(a)(2). The cross-testing rules appear in Treas. Reg. § 1.401(a)(4) 8(b).

[72] Treas. Reg. § 1.401(a)(4)-3(a)(2).

[73] Treas. Reg. § 1.401(a)(4)-8(b)(1)(B), effective for plan years beginning on or after January 1, 2002.

[74] Treas. Reg. § 1.416-1, M-10.

[75] Pub. L. No. 107-16, § 613(b), made permanent by Pub. L. No. 109-280, § 811 (PPA '06), adding a new sentence at the end of I.R.C. § 416(c)(2)(A).

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- 20%.

Each non-key employee who earns 1,000 hours of service during the applicable computation period must accrue a top heavy minimum benefit. An employee cannot fail to accrue a top heavy minimum benefit solely because his/her compensation is below a stated amount or he/she failed to make a mandatory contribution.[76]

§ 6.09 PROTECTION OF ACCRUED BENEFITS (ANTI-CUTBACK RULE)

The vesting and accrued benefit rules could be rendered meaningless if the employer were able to retroactively reduce an employee's accrued benefits. Thus, ERISA § 204(g) and Code § 411(d)(6) protect an employee's accrued benefit by prohibiting a reduction through a plan amendment.

While an employer is permitted to amend its plan to reduce or eliminate prospective accrual of benefits and/or allocations, it is generally not able to forfeit, or "cut-back," participants' benefits that have already accrued.[77] Note that there are notification rules that apply regarding the plan amendments affecting future benefit accruals.[78] The Code specifies that a plan may not be amended in a way that would reduce, or "cut-back," the accrued benefit that a participant has earned up to the effective date of the amendment.

[A] Meaning of a Plan Amendment

What is considered a plan amendment reducing accrued benefits for purposes of Code § 411(d)(6)? The regulations indicate that Code § 411(d)(6) is not limited to written instruments affecting plan provisions, but also extends to other transactions that have similar effects as plan amendments (*e.g.*, mergers, spinoffs, and transfers).[79] According to the Service, an employer's discretion in limiting the availability of certain optional forms of benefits to certain participants, but not all, is impermissible.[80] Such result applies regardless of whether there is a plan amendment.[81] Such discretion includes discretion to be exercised by the plan administrator, committee, trustee, actuary, fiduciary or any person other than the participant and/or spouse. Case law does not necessarily agree that an exercise of

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[76] Treas. Reg. § 416-1, M-4.

[77] I.R.C. § 411(d)(6)(A).

[78] These are referred to as ERISA § 204(h), notices that must be circulated to affected individuals in a timely fashion. Pub. L. No. 107-16, § 659 (EGTRRA '01), contains new notification requirements for future cutbacks in defined benefit or money purchase plans. Pub. L. No. 109-280, § 811 (PPA '06) has made these mandates permanent, keeping them in place past EGTRRA's original "sunset" date of Dec. 31, 2010.

[79] Treas. Reg. § 1.411(d)-4, Q&A-2(a)(3).

[80] Treas. Reg. § 1.411(d)-4, Q&A-4(a). In contrast, the legislative history of Pub. L. No. 98-397 (REA '84) indicates that reduction or elimination of an option as a result of discrimination in favor of employees who are officers, shareholders or highly compensated is a by-product of I.R.C. § 401(a)(4).

[81] Treas. Reg. § 1.411(d)-4. Q&A-4(a).

employer discretion is subject to Code § 411(d).[82]

The Treasury regulations liberalized the rules regarding elective transfers between qualified plans regardless of whether the benefit is immediately distributable.[83] Such transfers must be pursuant to a corporate merger or change in the participant's employment status. Under the regulations, the right to a particular medium of distribution is regarded as a protected benefit even though the right to a particular form of investment is not a protected benefit.[84]

[B] Meaning of a Reduction

What is considered a reduction in an accrued benefit? The regulations require all plan provisions be taken into account in determining the computation of the accrued benefits. This includes determination of years of service and break in service provisions for determining benefit accruals and actuarial factors (interest and mortality) for determining optional and early retirement benefits.[85] Plans that use a variable standard (*e.g.*, PBGC interest rate) for computing actuarial equivalence are not subject to the anti-cutback limitations unless the standard used is changed.[86] Changes in interest or mortality factors enacted by GATT do not violate the anti-cutback rules.[87]

In a recent decision, the Supreme Court rejected the argument that the anti-cut back rules apply only to amendments that change the dollar amount of the retiree's benefit and do not apply to suspensions of early or normal retirement benefits.[88] In that case, a multiemployer plan provided for a suspension of pension benefits for participants who retired before age 60 if they took certain "disqualifying employment."[89] At the time the plaintiffs retired, they took jobs as construction supervisors which was not a job classification that fell under "disqualifying employment" under the plan.[90] Two years later, the plan was amended to include construction supervisors in the list of job classifications; thus, the plaintiffs' benefits were suspended.[91] The Supreme Court held that a new condition could not be imposed upon a benefit that had already accrued.[92] In a recent IRS ruling, the Service has extended the time frame until January 1, 2007 for sponsors to adopt a

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[82] *See* Collignon v. Reporting Serv. Co., 796 F. Supp. 1136 (C.D. Ill. 1992) ("There is no indication that Section VIII of the Plan came about by plan amendment. Where there is no amendment altering the method of payment of benefits, the statute on its face does not apply.").

[83] Treas. Reg. § 1.411(d)-4, Q&A-3(b).

[84] Treas. Reg. § 1.411(d)-4, Q&A-2(b)(2).

[85] Treas. Reg. § 1.411(d)-3(b).

[86] Rev. Rul. 81-12, 1981-1 C.B. 228.

[87] Pub. L. No. 103-401, § 767(d)(2) (Retirement Protection Act of 1994) and Rev. Rul. 98-1, 1998-2 I.R.B. 5, modified by Rev. Ruls. 2001-51, 2001-2 C.B. 427 and 2001-62, 2001-2 C.B. 632.

[88] *See* Central Laborers' Pension Fund v. Heinz, 541 U.S. 739, 745-46 (2005).

[89] *Id.* at 742.

[90] *Id.*

[91] *Id.*

[92] *Id.* at 745.

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reforming amendment to comply with the results of the *Heinz* decision.[93]

[C] Meaning of "Accrued Benefits"

Initially the statute required that accrued benefits could not be decreased except as permitted in certain circumstances as noted under Code § 412(c)(8). The term "accrued benefit" was limited to benefits that began at the normal retirement age (*i.e.*, the normal retirement benefit). Hence, employers were free to amend plans to reduce or eliminate early retirement benefits and optional forms of payment. The Retirement Equity Act of 1984 ("REA '84") subsequently expanded the definition of accrued benefit not to be decreased by plan amendment to include "an early retirement benefit or a retirement-type subsidy" and "an optional form of benefit."[94] Such plan amendment prohibition applied only to service before the amendment and with respect to eligibility for early retirement or the retirement-type subsidy, for participants who satisfied the pre-amendment conditions of the subsidy.

Early retirement benefits included benefits provided under the plan prior to the normal retirement age. As these benefits may have been subsidized to encourage participants to terminate early, such subsidies would now have to be preserved under the accrued benefit rules. Such protection extended not only to early retirement benefits, but to retirement-type subsidies (*i.e.*, where the benefit at retirement exceeded the actuarial value of the plan's normal retirement benefit). Optional forms of benefits included alternative distribution options available under the plan (*e.g.*, ten year certain and life, lump sum), some of which may have been subsidized or not.

REA '84 authorized Treasury to issue regulations regarding the meaning of an optional form and retirement-type subsidy.[95] In 1988, the Treasury issued detailed final regulations, interpreting the statute broadly and imposing onerous requirements on plan sponsors, especially in regards to mergers and acquisitions.[96] The Service cited three reasons for its liberalization of the regulations:

- *Increased use of prototype plans.* The Service recognized that as plan sponsors change from one prototype plan to another with a different set of distributions, the regulations require the prior set of distributions (at least with respect to benefits accrued to date) be preserved under the new prototype.[97]
- *Plan mergers.* The Service acknowledged that plan mergers, especially in the corporate mergers and acquisition context, made economic and practical sense; however, the buyer was required to continue the prior benefit options for benefits accrued to date, increasing the cost and

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[93] *See* Rev. Proc. 2005-76, 2005-2 C.B. 1139.

[94] Pub. L. No. 98-397, § 301(a), amending I.R.C. § 411(d) and ERISA § 204(g).

[95] *See* I.R.C. § 411(d)(6)(B); ERISA § 204(g).

[96] Prop. Treas. Reg. § 1.411(d)-4 (63 Fed. Reg. 47214, September 4, 1988; modified 53 Fed. Reg. 48533, December 1, 1988).

[97] *Id.*

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complexity of administration. An easy solution was simply to terminate the prior plan, which resulted in the "leakage" of benefits.[98]

- *Direct rollovers.* The subsequent legislative enactment of the direct rollover rules partially solved the leakage problems, thus negating the requirement that all prior optional forms of payment be preserved.[99]

In March 2000, the Service issued proposed regulations, but only with respect to the issue of elimination or reduction of optional forms of benefits.[100] According to the American Bar Association Report, the regulations result in greater, not less leakage.[101] The real problem with leakage is the availability of the plan's lump sum distribution and Code § 411(d)(6) does not prevent such form of payment; in fact it prevents an employer from amending the plan to eliminate such form of payment. Final regulations under Code § 411(d)(6) were issued in September 2000, effective for plan amendments on or after September 6, 2000.[102]

The Code defines "accrued benefit" for purposes of a defined benefit plan as the benefit determined under the plan, expressed in the form of an annual benefit commencing at normal retirement age, and if the accrued benefit is expressed as an amount other than an annual benefit commencing at normal retirement age, the actuarial equivalent of such benefit.[103] Thus, alternative distribution forms (*e.g.*, alternative annuities, installments, lump sum distributions) and alternative distribution ages (*e.g.*, early retirement age) would clearly have to be provided on an actuarial equivalent basis. The Service's proposed and final 2000 regulations went beyond forms of distributions and ages of distribution and included the payment schedules, medium of distribution, portion of the benefit to which the distribution features apply, and election rights with respect to optional forms of payment as part of the participant's "accrued benefit."[104] The regulations state that distribution alternatives (including normal form) available for participant's accrued benefit, early retirement benefit, or retirement-type subsidies are considered optional forms.[105] Thus, alternate forms under the plan that are paid on substantially the same terms (*i.e.*, relating to timing, medium of distribution, election rights, etc.) may be eliminated.[106] Such interpretation has caused practical

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[98] *Id.*

[99] *Id.*

[100] Prop. Treas. Reg. § 1.411(d)-4, 65 Fed. Reg. 16547 (March 29, 2000).

[101] American Bar Association, Section of Taxation, Employee Benefits Committee: Comments Regarding the Internal Revenue Service and Treasury Department Proposal on Application of Section 411(d)(6) to Defined Contribution Plans (1999) at 44-45, available at http://www.abanet.org/ tax/groups/benefits/ebccom_411d6.html (stating "Code section 411(d)(6) does nothing to eliminate the lump sum form of payment. On the contrary, if a plan has a lump sum form of payment, Code section 411(d)(6) prevents the plan sponsor from amending the plan to eliminate it . . . the current regulations under Code section 411(d)(6) encourage leakage in the context of corporate mergers and acquisition.").

[102] Treas. Reg. § 1.411 (d)-4, 65 Fed. Reg. 53901 (September 6, 2000).

[103] I.R.C. § 411(a)(7)(A)(i), (c)(3).

[104] Prop. Treas. Reg. § 1.411(d)-4, Q&A-1(b)(1); Treas. Reg. § 1.411(d)-4, Q&A-1(b).

[105] Treas. Reg. § 1.401(a)(4)-4(e)(1).

[106] *Id.*

problems for employers in the contexts of adopting successor prototype plans and in mergers and transfers.[107]

[D] Protection of Subsidies

As the Code defines the accrued benefit as an annual benefit commencing at the normal retirement age, payment of the accrued benefit at a different date (*e.g.*, early retirement date) must be the actuarial equivalent of such benefit.[108] However, the availability and amount of early retirement benefits is also regarded as part of a participant's accrued benefit that is not subject to cut-back, even if the benefit exceeds the actuarial equivalent of the normal retirement benefit. However, early retirement window benefits are not regarded as part of the accrued benefit unless there is a pattern of repeated plan amendments with similar window benefits.[109]

> **Example:** A defined benefit plan provides a normal retirement benefit (NRB) = 100% × FAE/65/life only or J&S, subject to Code §§ 410(a)(17) and 415. The plan also provides an early retirement benefit (ERB) for participants age 60 + 10 years of service, reducing the NRB by 5% for each year prior to normal retirement age of 65. Paul Participant (unmarried) decides to opt for ERB at age 60 (with 10 years of service) when FAE = $92,000. His NRB = 100% × $92,000/65/life only; his ERB is reduced 5% × 5 years for early commencement = 25% reduction. Thus, Paul is entitled to ERB = [$92,000 − 25% × $92,000] = $69,000/60/life only. Since a true actuarial equivalence for ERB is normally 6 ⅔%, this plan subsidizes ERB by charging only a 5% cost for early commencement.

For plans with age and/or service eligibility criteria for early retirement benefits, all the circuits affirm that such criteria may not be reduced or eliminated once made available to a given group of participants. Hence, if the plan's early retirement benefit is contingent upon attainment of age 55 and 20 years of service, a participant age 44 with only 19 years of service must be afforded the opportunity to "grow into" the eligibility for early retirement benefits. The early retirement subsidy may be changed, however, with respect to accruals for future service with the employer. Post-retirement cost of living increases provided under the plan document are considered benefits protected by Code § 411(d)(6).[110]

The Code has deferred to regulations as to the interpretation of "retirement-type subsidy," and the Senate Committee Report noted that it viewed a "subsidy" as a

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[107] To illustrate the Service's expansive definition of an "accrued benefit," the Service initially took the position that a participant's minimum required distribution date was a protected optional form of benefit. Thus, in 1996, when the Code modified the minimum distribution requirements so as to permit non-5% owners who had not yet retired to continue deferral of benefits until actual retirement instead of forcing a distribution at age 70½, the Service announced that eliminating such right to a participant to receive a pre-retirement distribution after attaining age 70½ would be a cut-back of benefits. *See* Prop. Treas. Reg. § 1.411(d)-4, Q&A-10. The Service has subsequently withdrawn this position.

[108] *See* I.R.C. § 411(c)(3); Treas. Reg. § 1.411(a)-7(a)(1).

[109] Treas. Reg. § 1.411(d)-4, Q&A-1(c)(1).

[110] *See* Shaw v. I.A.M. Pension Plan, 563 F. Supp. 653 (C.D. Cal., 1983), *aff'd*, 750 F.2d 1458 (9th Cir. 1985); *accord* Hickers v. Chicago Truck Drivers Union, 980 F.2d 465 (7th Cir. 1992). *But see* Priv. Ltr. Rul. 199723053.

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benefit that continued after retirement.[111] Proposed regulations address this issue but do not explicitly define the term "retirement-type subsidy."[112] Several courts have defined such term as the excess value of such benefit over the actuarial equivalent value of the normal retirement benefit.[113] But the question of whether a subsidy continues after retirement has been the subject of some litigation.[114] This question is most commonly discussed in the context of plan shutdown benefits. Shutdown benefits are regarded as retirement-type benefits if their payment continues beyond retirement age; however, shutdown benefits that are regarded as supplemental or severance-type benefits are not considered retirement-type benefits.[115]

The Service has held that plant shutdown benefits that are retirement-type benefits, not ancillary benefits, may not be reduced or eliminated.[116] The case law does not necessarily support the Service's position. Such cases do not characterize shutdown benefits as accrued benefits, as they could not be characterized as a benefit commencing at normal retirement age.[117]

Examples of plan features that are not considered part of the "accrued benefit" under the regulations, and thus may be altered or eliminated from the plan include:[118]

- Social Security supplements;
- Plan loans;
- The right to a particular form of investment or to direct investments;
- Allocation date for contributions, forfeitures and earnings; and
- The right to make pre-tax or after-tax contributions.

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[111] I.R.C. § 411(d)(6)(B)(i), as amended by Pub. L. No. 107-16, § 645(b)(3) (EGTRRA '01), changes made permanent by PPA '06, § 811. *See also* S. Rep. No. 98-575, p. 30.

[112] Prop. Treas. Reg. § 1.411(d)-3(e).

[113] *See* Ashenbaugh v. Crucible Inc., 1975 Salaried Retirement Plan, 854 F.2d 1516, 1521 (3d Cir. 1988); Dade v. North Am. Philips Corp., 68 F.3d 1558, 1562 (3d Cir. 1995).

[114] *See* Bellas v. CBS, Inc., 73 F. Supp. 2d 500 (W.D. Pa. 1999) (court held that the elimination of the normal actuarial reduction for early commencement of benefits for those participants whose employment was involuntary terminated was a retirement subsidy as the benefit continued beyond the participant's normal retirement age). *But see* Ross v. Pension Plan for Hourly Employees of SKF Indus., Inc., 847 F.2d 329 (6th Cir. 1988) (Sixth Circuit held that an actuarial subsidy used in a shutdown benefit was not a retirement-type subsidy).

[115] *See generally* Gen. Couns. Mem. 39869 (April 6, 1992); *Ross*, 847 F.2d 329.

[116] Prop. Treas. Reg. § 1.411(d)-3, 69 Fed. Reg. 13769 (March 24, 2004); Gen. Couns. Mem. 39869 (April 6, 1992).

[117] *See Ross*, 847 F.2d 329 (6th Cir. 1998); Harms v. Cavenham Forest Indus., 984 F.2d ; Wallace v. Cavenham Forest Indus., 707 F. Supp. 455 (D. Ore. 1989); Davis v. Burlington Indus., Inc., 966 F.2d 890 (4th Cir. 1992); Blank v. Bethlehem Steel Corp., 926 F.2d 1090 (11th Cir. 1991); Richardson v. Pension Plan of Bethlehem Steel Corp., 67 F.3d 1462 (9th Cir. 1995).

[118] Treas. Reg. § 1.411(d)-4, Q&A-1(d).

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[E] Elimination of Optional Forms of Payment

The final 2000 Treasury regulations permitted profit sharing plans to eliminate all optional forms of benefits except the lump sum payment option, provided such option is identical to the optional forms being eliminated and such amendment to the plan is effective no earlier than (1) the 90th day after the participant received an updated summary plan description, and (2) the first day of the second plan year in which the amendment was adopted.[119] Elimination of annuity options require spousal waiver of this right. Money purchase and defined benefit plans could eliminate various optional annuity forms of payment, but had to continue to offer the joint and survivor annuity option.[120]

To fully appreciate the value of optional forms of payment, the following example illustrates the subsidy that may be provided through an employer plan:

> **Example:** Assume Paul Participant (age 45) has an accrued benefit of $5,000/65/life only and terminates employment, requesting a lump sum distribution from the plan. Under the plan's assumptions of 6% interest rate and 1983 IAM-M mortality table, the value of such benefit at age 65 is worth $57,300. Discounting the value from age 65 to 45, the lump sum amount of Paul's accrued benefit is $17,866.

In an effort to promote plan mergers without unduly burdening plan sponsors with multiple optional forms, EGTRAA '01 provided that a defined contribution plan to which benefits are transferred beginning in 2002 will not be in violation of the anti-cutback rules even though all forms of distributions previously available under the transferor plan are no longer available, provided:

- The transferor plan is another defined contribution plan that is directly transferring the participant's or beneficiary's benefit accrued under such plan
- The terms of the transferor and the transferee plan authorize the transfer
- The transfer is pursuant to a voluntary election by the participant/ beneficiary, made after receiving notification of the consequences of such transfer
- The transferee plan permits the participant/beneficiary to receive his/her benefits under the transferree plan in the form of a lump-sum distribution.
- These changes did not apply to survivor annuities under Code § 417; thus transferee plans subject to joint and survivor rules continued to be subject to the anti-cutback rules.[121]

Congress also directed the Treasury to issue regulations whereby the elimination or reduction of certain early retirement benefits or retirement-type subsidies would not "cut back" on a participant's benefits if such elimination or reduction caused a significant burden or complexity for the plan and if the end results were *de*

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[119] Treas. Reg. § 1.411(d)-4, Q&A-2(e)(1).

[120] I.R.C. § 401(a)(11).

[121] Pub. L. No. 107-16, § 645.

minimus for the participant.[122] In response, the Treasury issued proposed regulations under this provision in March 2004, providing guidance on this topic.

Treasury issued comprehensive proposed regulations under Code § 411(d)(6) permitting the elimination of optional forms provided (1) they are redundant, (2) the amendment is not effective for 90 days, and (3) if the retained optional forms' value is less than the actuarial equivalent value of the form eliminated or there is an alternative annuity starting date, a showing must be made that continuation of such optional forms would be burdensome and is of *de minimis* value.[123] In determining whether optional forms are redundant, the Service provides six families of optional form payments: (1) 50% to 100% joint and survivor annuities, (2) 1% to 49% joint and survivor annuities, (3) 0 to 10 year certain and life annuities, (4) more than 10 year certain and life annuities, (5) 0 to 10 year level installment payments, and (6) more than 10 year level installment payments.[124] Optional forms are deemed redundant if the retained optional form is available to the participant, is within the same family of optional forms, and is available without restrictions that materially differ from the retained form.[125]

Instead of eliminating optional forms through the redundancy rules, the regulations permit optional forms to be eliminated if (1) certain core options continue after the plan amendment, (2) the amendment is not effective for four years, and (3) if the retained optional forms' value is less than the eliminated optional form value or the annuity starting date is different, a showing must be made that the eliminated forms are burdensome and of *de minimis* value.[126] Core options include straight life annuity, 75% joint and survivor annuity, 10 year certain and life annuity, and the most valuable option for a participant with a short life expectancy (*i.e.*, the option at each annuity start date expected to have the greatest value taking into account payments during the participant's life and continuing after death).[127]

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[122] Pub. L. No. 107-16, § 645(b)(1), amended I.R.C. § 411(d)(6)(B).

[123] Prop. Treas. Reg. § 1.411(d)-3(c). The determination of burdensomeness is a facts and circumstances test. The regulations presume that multiple annuity starting dates and multiple actuarial factors are complex and burdensome; however, the plan amendment may not substitute new dates or factors, nor create complexities of its own.

[124] *Id.*

[125] *Id.*

[126] Prop. Treas. Reg. § 1.411(d)-3(d).

[127] *Id.*

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CLASS DISCUSSION PROBLEMS

Note: Remember that a plan's accrued benefit formula need only satisfy one of the Code § 411(b) standards. Examples and homework problems may test the proposed plan's accrued benefit formula under all three standards so it is understood how the standard is applied in various plan scenarios.

NRB = Normal Retirement Benefit

NRA = Normal Retirement Age

AB = Accrued Benefit

FAE = Final Average Earnings

Yrs/65/life annuity or J&S = an annual life annuity for an unmarried participant beginning at age 65 or an annual life annuity for a married participant with a survivor annuity for the deceased participant's spouse beginning at age 65

AAC = Average Annual Compensation

Example 1: When the plan's NRB formula under a defined benefit plan is described as a unit formula (*e.g.*, NRB = 2% × FAE× years/65/life annuity or J&S), it is easy to ascertain the accrued benefit formula — it is simply the same as the NRB formula. (*e.g.*, AB = 2% × FAE × years/65/life annuity or J&S). The only difference between the two formulas is that the NRB provides the use of FAE during the latter years of service to serve as the salary basis for all prior year accruals, whereas the AB provides the use of the FAE determined as of the time of participant's termination as the salary basis for all prior year accruals. For most individuals, the FAE figure at 40 is considerably less than the FAE figure at 65; however, the employer will apply the FAE figure in existence at the time of termination as the basis for the accrued benefit formula.

Example 2: When the NRB formula under a defined benefit plan is described as a fixed benefit (*e.g.*, 80% of FAE/65/life annuity or J&S), then the employer must decide upon an accrued benefit formula so that participants accrue benefits over their years of participation in order to attain the NRB should they reach the plan's NRA. Clearly an accrued benefit formula that has a higher annual accrual rate for all years of participation (*e.g.*, 8%× years of participation (cap 10)/65/life annuity or J&S) is front-loading and does not cause a Code § 411(b) concern, but may result in considerable costs for the employer. In contrast, a smaller annual accrual rate for all years of participation (*e.g.*, 2% × years of participation (cap 40)/life annuity or J&S) may cost the employer far less but may provide minimal benefits, especially for younger employees with lower compensation amounts. Varying the annual accrual rates under the accrued benefit formula according to specific years of participation (*e.g.*, (2%× first 10 years of participation + 4% × next 10 years of participation + 5% × next 6 years of participation)/65/life annuity or J&S) is possible provided the increase in accrual rates satisfies one of the tests prescribed under the Code § 411(b).

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Example 3 (Illustrating 3% Rule):[128] XYZ Corporation has a defined benefit plan with a flat dollar NRB = AB = [$4/month × years of participation]/65/life only or J&S. The plan has a minimum age for participation of 21 and normal retirement age of 65, but there is no limit on years of participation. In plans that do not cap years of participation at 33 ⅓ years, the 3% Rule is generally not going to be available.

The Plan's annual accrual is $4/month, whereas the 3% Rule requires an annual accrual of 3% of the Theoretical Maximum NRB. For a participant entering the plan at age 21 and retiring at age 65, the Maximum NRB = [$4/month × 44 years]/65/life only or J&S = $176/month/65/life only or J&S. 3% of the Theoretical Maximum NRB would be $5.28/month. Since the plan's annual accrual is $4/month, which is less than the 3% minimum of $5.28/month, the plan does not satisfy the 3% Rule.

Example 4 (Illustrating 133⅓% Rule):[129] ABC Corporation has a defined benefit plan that provides an annual benefit at age 65 of a varying percentage of a participant's FAE (using highest 3 years of compensation). The percentage is 2% for each of the first 5 years of compensation, 1% for each of the next 5 years of compensation and 1½% for each year thereafter. The plan does not satisfy the 133⅓% rule because the rate of accrual for years of participation in excess of 10 (1½%) exceeds the accrual rate for years 6 through 10 (1%) by 150% (which is more than 133⅓%).

Example 5 (Illustrating Fractional Rule):[130] J Corporation has a defined benefit plan that provides AB and NRB = 1% × years of participation × AAC/65/life only or J&S. AAC uses the final 10 years of compensation in determining the average. The plan year is the calendar year. In this example, B became a participant at age 45 in year 1 and had the following compensation history:

Year	Compensation	Year	Compensation
1	$17,000	7	$23,000
2	18,000	8	25,000
3	20,000	9	26,000
4	20,000	10	29,000
5	21,000	11	32,000
6	22,000		

B's AAC over 11 years is $23,000; however, utilizing only the last 10 years of compensation B averaged a higher AAC of $23,600.

Under the Plan's Accrued Benefit formula as of B's 11th year of participation provides an annual benefit of [1% × 11 × $23,000]/65/life only or J&S = $2,530/yr/65/life only or J&S.

Under the fractional rule (which is limited to compensation during the last 10 years of participation), the minimum accrual at the end of 11 years of participation

[128] Treas. Reg. § 1.411(b)-1(b)(1)(iii), Example (1).

[129] Treas. Reg. § 1.411(b)-1(b)(2)(iii), Example (2).

[130] Treas. Reg. § 1.411(b)-1(b)(3)(iii), Example (3).

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should be at least [1½% × 20% × $23,600]/65/life only or J&S = $2,596/yr/65/life only or J&S. Since the plan's accrued benefit is not sufficient to meet the fractional rule minimum, it does not qualify under the fractional rule.

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HOMEWORK PROBLEMS FOR CHAPTER 6

1. ABC Corp. has a defined benefit plan for union employees. The plan's benefit formula is NRB = AB = 2% × FAE × years of benefit service (capped at 30)/65/life only or J&S

A year of benefit service is defined as a plan year is which the participant completes 2,000 hours of service. The plan year is the calendar year. Years of service completed prior to becoming a participant are not counted as benefit service. Partial years of benefit service are determined as follows:

Hours of Service	Percentage of Full Year of Benefit Service
1,000	50
1,001– 1,200	60
1,201– 1,400	70
1,401 – 1,600	80
1,601 – 1,800	90
1,801 – 2,000	100

For the following participants, calculate their years of benefit service:

a. John

Date of Hire:	1/1/00							
Date of Participation:	1/1/01							
Hours worked:	2000	2001	2002	2003	2004	2005	2006	2007
	2005	1800	1500	900	2000	2000	2000	2000

b. Mary

Date of Hire:	2/1/02					
Date of Participation:	1/1/03					
Hours worked:	2002	2003	2004	2005	2006	2007
	1800	2000	2100	1500	1200	2000

c. Sue

Date of Hire:	3/1/01						
Date of Participation:	1/1/04						
Hours worked:	2001	2002	2003	2004	2005	2006	2007
	500	1200	1400	800	2000	2000	2000

2. Does ABC Corp's defined benefit plan meet any of the accrued benefit tests for defined benefit plans? If so, which tests are satisfied? Explain.

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3. What is John's annual accrued benefit under the plan as of 12/31/07, if the average of his last 3 years of compensation is $35,000?

4. A medical clinic, owned by two doctors (A and B), is considering adopting a defined benefit plan as A is age 60 and B is age 55. To maximize benefits from a qualified plan, the NRB formula will be 100% × FAE/65/life only or J&S. Discuss the optimal accrued benefit formula that should be used.

5. A plan's NRB = 75% × FAE/65/life only or J&S, and AB = 2% × FAE× years (cap 37½)/65/life only or J&S. Does the plan's AB formula satisfy the 3% Rule? The 133 ⅓ Rule? The Fractional Rule?

6. An employer with a relatively young workforce is considering the following types of unit credit NRB formula (with the AB formula being the same as the NRB):

a. NRB = 1% × FAE × years (no cap)/65/life only or J&S

b. NRB = 2% × FAE × years (cap 50)/65/life only or J&S

c. NRB = 4% × FAE × years (cap 25)/65/life only or J&S

d. NRB = 8% × FAE × years (cap 12½)/65/life only or J&S

What considerations should the employer keep in mind in deciding which formula to use?

If the employer decides to use the third formula, what is the difference between defining the amount portion of the NRB as 100% × FAE, instead of 4% × FAE × years (cap 25)?

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ANSWERS TO HOMEWORK PROBLEMS FOR CHAPTER 6

1.

Years of Benefit Service	Participant
5.7	John
4.4	Mary
3.7	Sue

2. The formula meets the 3% rule. Under the formula, the theoretical maximum NRB is 60% times last 3 years of compensation. 3% of this maximum benefit is 1.8% times last 3 years of compensation. Since 2% is greater than 1.8%, the formula meets the 3% rule.

Since there is no change in the benefit formula for any year, the formula meets the 133 ⅓% rule.

The formula should meet the fractional rule. If Employee A at age 60 has an average pay for the last 3 years of 30,000 and 25 years of benefit service, his maximum benefit at age 65 (NRA) would be $18,000 (60% times $30,000). A's benefit at age 60 cannot be less than $15,000 = ($18,000 × 25/30). Since his benefit under the formula would be 50% × 30,000, or $15,000, the formula satisfies the Fractional Rule.

3. John's annual accrued benefit as of 12/31/07 is $3,990. (2% of 35,000 multiplied by 5.7 years of benefit service).

4. If both A and B retire from the clinic at age 65, practically it will not matter how the accrued benefit formula is set. However, if there are other employees or if the clinic dissolves when the older doctor first retires, the determination of the accrued benefit formula will be extremely important; also in funding benefits under the plan, the accrued benefit formula must be utilized.

Following are two extremes of an AB formula:

Formula 1: AB = [0% × FAE× (years prior to age 64) + 100% × FAE × (year of age 65)]/65/life only or J&S

Formula 2: AB = 100% × FAE (year 1) + 0% × FAE × (all later years)]/65/life only or J&S

The former is an extreme form of backloading as nothing is accrued until the year between age 64 and age 65 and negates any vesting schedule. It clearly is impermissible under Code § 411(b). The latter is excessively costly and provides no motivation to continue service after the first year. Also the cost could not be deducted in a single year.

The employer could consider an annual uniform accrual rate for the AB formula:

AB = 5%× FAE× years (capped at 20)/65/life only or J&S

Since doctor A is age 60 and doctor B is 55, the formula would have to count prior service; if A and B will not have 20 years at retirement, such a formula will cause

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funding problems as they will not be accruing a sufficient amount to pay a NRB of 100% × FAE at age 65. Generally the number of years capped in the AB formula represents the typical length of service for a participant who is eligible for NRB. If the cap is too low, participants accrue the full AB benefit before becoming eligible for NRB and therefore have no incentive to stay with the employer; if the cap is too high, participants will not accrue the full amount of the NRB by the time they attain age 65, causing funding problems for the employer.

A graded AB formula may be desirable if the employer experiences significant turnover problems at certain points in the participants' service; a greater accrual in a later year of service may give the participant an incentive to continue service with the employer. Also participants who termination early receive less than what they would have earned under a uniform formula.

5. The 3% Rule was designed to permit plans to accrue benefits at a constant annual 3% of the ultimate normal retirement benefit. Mathematically, if the accrued benefit formula accrues exactly at a rate of 3% of the NRB, the full benefit must be achieved in 33⅓ years. If the plan accrues at a faster rate (*e.g.*, 4% of the NRB), the full benefit will be achieved in 25 years; a rate of 5% of the NRB results in a full benefit in 20 years. Thus, the greater the annual accrual rate, the faster the accrual and the more costly the benefit. In this example, an annual accrual rate of 2% of FAE (capped at 37½ years) does not satisfy the 3% rule. Under the 3% rule, 3% of (75% of FAE) = 2.25% must be the minimum accrual rate each year; the formula provides only 2%, which is why it takes longer than 33⅓ years to achieve the full 75% × FAE (normal retirement benefit).

Since the plan's accrual rate is a uniform 2% rate, it satisfies the 133⅓ Rule.

The fractional rule was designed to accrue the plan's NRB over the employee's actual number of years of participation; thus its accrued benefit formula earns the NRB proportionately based on an individual's expected years of participation. Thus, younger employees with a 40-year expected participation would accrue 1/40 or 2.5% of the NRB each year until retirement. In contrast, older hires with a 10-year expected participation would accrue 1/10 or 10% of the NRB each year until retirement. The result is actually to front-end the accrual based on years of participation. Since this plan's accrual rate is a uniform 2% rate, it does not satisfy the fractional rule as it will not accrue a sufficient amount for the older hires.

6. Each of the formulas has advantages/disadvantages.

a. NRB = 1%× FAE× years (no cap)/65/life only or J&S

The first formula with an accrual rate of 1% does not provide sufficient retirement income even if the participant has 50 years with the employer. It certainly will not cost the employer very much, but then it will not be valued much by the employees, especially the younger ones.

b. NRB = 2%× FAE× years (cap 50)/65/life only or J&S

The second formula would provide more than adequate retirement income if a participant actually accrues 50 years of participation. That is most unlikely in our current workforce environment where the typical employee stays with an employer for about 7 years.

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c. NRB = 4%× FAE× years (cap 25)/65/life only or J&S

The third formula is more than adequate if the career service participant is expected to have 25 years at retirement; however, the formula is extremely generous for participants with less service (*e.g.*, after 10 years, the AB benefit is 40% of FAE, which is very generous, and therefore very costly for the employer).

d. NRB = 8%× FAE× years (cap 12½)/65/life only or J&S

The fourth formula is not only too expensive, but it also provides no incentive for a participant to stay with the employer beyond 12½ years.

If the employer decides on the third formula and defines AB as 4% × FAE× years (cap 25)/65/life only or J&S, there is a great deal of difference between defining the NRB as 100%× FAE/65/life only or J&S, versus 4% × FAE× years (cap 25)/65/life only or J&S. Under the vesting rules, the NRB formula must be fully vested at the earlier of age 65 or the plan's normal retirement age (which is age 65 here). If the NRB amount is 100% × FAE, it must be fully accrued by age 65 for older hires, even if they do not have 25 years of participation; in contrast, the NRB amount of 4% × FAE requires 25 years of participation in order for the participant to attain the full 100%× FAE benefit.

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