PLAN DISTRIBUTIONS

EGTRRA Relaxes Anti-Cutback Rules

By MELANIE N. ASKA KNOX

EGTRRA has significantly relaxed the anti-cutback rules and greatly expanded Treasury's regulatory authority to provide exceptions to those rules, even the rules on reduction or elimination of accrued benefits or subsidies. The true extent of the changes will not be known until Treasury releases final regulations, which are due before 2004.

The Retirement Equity Act of 1984 (REA) added anti-cutback rules to the Internal Revenue Code (Code) and the Employee Retirement Income Security Act of 1974 (ERISA). These rules generally provide that a plan will not be treated as satisfying the minimum vesting standards of Code Section 411 and ERISA Section 204 if a participant's accrued benefit is decreased by a plan amendment or by a transaction, such as a plan merger or a direct transfer of assets and liabilities, having the same effect as a plan amendment.

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the anti-cutback rules under Code Section 411(d)(6)(B) and ERISA Section 204(g) essentially provided that any plan amendment (or transaction having the effect of a plan amendment) that reduced or eliminated any accrued early retirement benefit or retirement-type subsidy, or that eliminated an optional form of distribution associated with an accrued benefit, would violate minimum vesting standards. The Secretary of the Treasury was authorized, however, to issue regulations that would provide exceptions to the anti-cutback rule forbidding plan amendments (or transactions) that eliminate optional forms of distribution; in any case, the Secretary's regulatory authority did not extend to any plan amendment (or transaction) that would have the effect of eliminating or reducing an accrued early retirement benefit or retirement-type subsidy. [I.R.C. § 411(d)(6)(B) and ERISA § 204(g)(2), each as in effect prior to EGTRRA]

Final Treasury regulations that were issued in 1988 and in 2000 provided detailed guidance on the extent to which certain plan amendments (and transactions having the effect of plan amendments) could—or could not—eliminate optional forms of distribution associated with already-accrued benefits. The 2000 final Treasury regulations, which generally were favorably received by plan sponsors and benefits practitioners alike, allowed only defined contribution plans to eliminate, by plan amendments or by voluntary direct transfers, certain optional forms of distribution that were associated with already-accrued benefits, provided certain conditions were met. Of course, there have been no Treasury regulations since REA that permitted the reduction or elimination of accrued early retirement benefits or retirement-type subsidies by means of plan amendment or otherwise, since any such regulations were expressly prohibited by Code Section 411(d)(6)(B) and ERISA Section 204(g)(2), each as in effect prior to EGTRRA.

EGTRRA has rebuilt the basic framework of the anti-cutback rules. In a nutshell, EGTRRA's new anti-cutback rules essentially provide that as long as certain statutory requirements are met, a defined contribution plan, by plan amendment or by voluntary direct transfer of benefits, may eliminate certain optional forms of distribution associated with already-accrued benefits. [I.R.C. § 411(d)(6)(D) and (E), as added by EGTRRA § 645(a)(1); ERISA § 204(g)(4) and (5), as added by EGTRRA § 645(a)(2)] Even more significantly, EGTRRA has greatly expanded the Department of the Treasury's regulatory authority to provide exceptions to the anti-cutback rules, even as they apply to the reduction or elimination of accrued benefits or subsidies. [EGTRRA § 645(b)]

Specifically, EGTRRA authorizes the Secretary of the Treasury to issue final regulations, no later

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than December 31, 2003, that would provide exceptions to the anti-cutback rules for "any plan amendment which reduces or eliminates benefits or subsidies which create significant burdens or complexities for the plan and plan participants, unless such amendment adversely affects the rights of a participant in a more than *de minimis* manner." [EGTRRA § 645(b)] EGTRRA's new anti-cutback rules apply to plan amendments and voluntary direct transfers that are adopted or made in plan years beginning after December 31, 2001, but the final regulations that EGTRRA requires Treasury to issue before 2004 will apply only to plan years beginning after December 31, 2003, unless those regulations specify an earlier effective date. [EGTRRA § 645(a)(3),(c)]

Although the extent to which Treasury will exercise its broader regulatory authority-remains to be seen, any post-EGTRRA regulations that flesh out the new exceptions to the anti-cutback rules could reasonably be expected to offer significant additional relief to plans, plan sponsors, and plan participants.

SOME VOLUNTARY, DIRECT TRANSFERS MAY ELIMINATE SOME FORMS OF DISTRIBUTION

Under EGTRRA, a direct transfer of accrued benefits from one defined contribution plan to another will *not* be treated as reducing a participant's or beneficiary's accrued benefit in violation of the anti-cutback rules under Code Section 411(d)(6) and ERISA Section 204(g) even though the transferee plan does not provide all of the forms of distribution that were previously available under the transferor plan if *all* of the following conditions are met:

1. The transferee plan receives from the transferor plan a direct transfer of the participant's or beneficiary's accrued benefit under the transferor plan, or the transferee plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employers within a multiple employer plan).
2. The terms of both the transferor plan and the transferee plan authorize the transfer.
3. The transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary receives a notice describing the consequences of making the election.
4. The transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a single-sum distribution.

[I.R.C. § 411(d)(6)(D)(i), as added by EGTRRA § 645(a)(1); ERISA § 204(g)(4)(A), as added by EGTRRA § 645(a)(2); Staff of the Joint Committee on Taxation 107th Cong., Summary of Provisions Contained in the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (May 26, 2001) (JCX-50-01) at157 [hereinafter referred to as the Statement of Managers]]

The new EGTRRA rules apply to plan mergers and other transactions having the effect of a direct transfer, including consolidations of benefits attributable to different employers within a multiple employer plan. [I.R.C. § 411(d)(6)(D)(ii), as added by EGTRRA § 645(a)(1); ERISA § 204(g)(4)(B), as added by EGTRRA § 645(a)(2)] The new rules, however, do not modify pre-EGTRRA requirements relating to survivor annuities under Code Section 417. Thus, as under pre-EGTRRA law, under the new EGTRRA rules, a defined contribution plan that is the transferee of a defined contribution plan that is subject to the joint and survivor rules (e.g., a money purchase pension plan) also will be subject to those rules. [Statement of Managers, at 157]

The new EGTRRA rules apply to direct transfers, plan mergers, and other transactions having the effect of a direct transfer that occur after December 31, 2001. [EGTRRA § 645(a)(3); Statement of Managers, at 159]

Prior to EGTRRA's enactment, the IRS had issued, on September 6, 2000 [65 Fed. Reg. 53901], final regulations that also permitted certain voluntary, direct transfers between defined contribution plans that had not been permitted under the 1988 final Treasury regulations under Code 411(d)(6)(B). Under the 2000 final Treasury regulations, a direct transfer of a participant's entire benefit from one defined contribution plan to another that resulted in the elimination or reduction of Section 411(d)(6) protected benefits would not violate the anti-cutback rules only if *all* of the following requirements were met:

1. **Voluntary election.** Under the 2000 final Treasury regu-

lations the transferor plan had to provide that the transfer was conditioned on a voluntary, fully informed election by the participant to transfer his or her entire benefit to the transferee plan. Alternatively, instead of the transfer, the participant had to be offered the chance to retain his or her Section 411(d)(6) protected benefits under the transferor plan (or if that plan was terminating, to receive any optional form of benefit for which the participant was eligible under the plan as required by Code Section 411(d)(6)). [Treas. Reg. § 1.411(d)-4, Q&A 3(b)(1)(i), as issued on Sept. 6, 2000 (65 Fed. Reg. 53901)]

2. **Types of plans to which transfers could be made.** In general, the 2000 final Treasury regulations permitted voluntary direct transfers only between same-type defined contribution plans. Benefits could be directly transferred only from a money purchase pension plan to another money purchase pension plan, from a 401(k) plan to another 401(k) plan, or from a Section 4975(e)(7) employee stock ownership plan (ESOP) to another such ESOP. Benefits could, however, be directly transferred from a profit sharing plan (other than a 401(k) plan) or from a stock bonus plan (other than an ESOP) to any other type of defined contribution plan. [Treas. Reg. § 1.411(d)-4, Q&A 3(b)(1)(ii), as issued on Sept. 6, 2000 (65 Fed. Reg. 53901)]
3. **Circumstances under which transfers could be made.** Under the 2000 final Treasury regulations, a voluntary direct transfer could be made from one defined contribution plan to another only on the occurrence of one or more enumerated triggering events, specifically, asset or stock acquisitions, mergers, or other similar transactions involving a change in employer of the employees of a trade or business (i.e., an acquisition or disposition within the meaning of Treasury Regulations Section 1.410(b)-2(f)) or in connection with the participant's change in employment status to an employment status with respect to which the participant was not entitled to additional allocations under the transferor plan. [Treas. Reg. § 1.411(d)-4, Q&A 3(b)(1)(iii), as issued on Sept. 6, 2000 (65 Fed. Reg. 53901)]

Like the new EGTRRA rules that permit certain voluntary, direct transfers between defined contribution plans, the 2000 final Treasury regulations provided relief only from Code Section 411(d)(6)'s anti-cutback rules, and not from other applicable qualification requirements, such as the survivor annuity requirements of Code Sections 401(a)(11) and 417 or the vesting requirements of Code Section 411(a)(10). The 2000 final Treasury regulations also specified that a defined contribution plan's elective transfer feature was an "other right or feature" within the meaning of Treasury Regulations Section 1.401(a)(4)-4(e)(3), the availability of which would be subject to the nondiscrimination requirements of Code Section 401(a)(4) and Treasury Regulations Section 1.401(a)(4)-4. [Treas. Reg. § 1.411(d)-4, Q&A 3(b)(2) and (3), as issued on Sept. 6, 2000 (65 Fed. Reg. 53901)]

By their terms, the 2000 final Treasury regulations on voluntary direct transfers between defined contribution plans first became effective with respect to such transfers made on or after September 6, 2000. [Treas. Reg. § 1.411(d)-4, Q&A 3(d), as issued on Sept. 6, 2000 (65 Fed. Reg. 53901)] EGTRRA's provisions governing voluntary direct transfers between defined contribution plans, which in many important respects are less restrictive than the 2000 final Treasury regulations, presumably replace those regulations, effective with respect to any such transfer occurring during a plan year beginning after December 31, 2001. It appears that EGTRRA's voluntary direct transfer rules are less restrictive than the 2000 final Treasury regulations in the following ways:

1. The new EGTRRA rules apparently do not require that voluntary, direct transfers generally be made only between defined contribution plans of the same type. Presumably, then, under the new EGTRRA rules, such a transfer might be allowed to be made from a money purchase pension plan to a profit sharing plan (including a 401(k) plan) or a stock bonus plan (including an ESOP); from a 401(k) plan to a money purchase pension plan, a profit sharing plan (regardless of whether it is also a 401(k) plan), or a stock bonus plan (including an ESOP); or finally, from an

ESOP to a money purchase pension plan, a profit sharing plan (regardless of whether it also is a 401(k) plan), or a stock bonus plan (regardless of whether it is also an ESOP).

2. The new EGTRRA rules apparently do not require a specific triggering event (e.g., a corporate transaction or change in employment status) in order for a participant to make a direct transfer from one defined contribution plan to another.
3. The new EGTRRA rules also require the transferee plan to have a single sum distribution option with respect to the transferred benefits. The 2000 final Treasury regulations do not contain this requirement.

Of course, the true extent of any differences between the 2000 final Treasury regulations and the new EGTRRA rules will not be known completely until the IRS issues final regulations—presumably, before 2004—under EGTRRA. Consequently, both plan sponsors and practitioners must grapple with a certain level of uncertainty about voluntary direct transfers between defined contribution plans that are made after December 31, 2001, and before those final regulations are published.

SOME AMENDMENTS MAY ELIMINATE SOME FORMS OF DISTRIBUTION

Under EGTRRA, except to the extent provided in regulations to be issued by the Secretary of the Treasury, a defined contribution plan will not be treated as reducing a participant's accrued benefit in violation of the Code's and ERISA's anti-cutback rules if *all* of the following conditions are met:

1. A plan amendment eliminates a form of distribution previously available under the plan.
2. A single-sum distribution is available to the participant at the same time or times as the form of distribution eliminated by the amendment.
3. The single-sum distribution is based on the same or greater portion of the participant's accrued benefit as the form of distribution that is eliminated by the amendment.

[I.R.C. § 411(d)(6)(E), as added by EGTRRA § 645(a)(1); ERISA § 204(g)(5), as added by EGTRRA § 645(a)(2); Statement of Managers, at 157–158]

The new rules apply to plan amendments that are made after December 31, 2001. [EGTRRA § 645(a)(3); Statement of Managers, at 159]

The 2000 final Treasury regulations also permitted defined contribution plans to be amended to eliminate, under certain circumstances, some alternative forms in which an account balance could be paid. Under the 2000 final Treasury regulations, a defined contribution plan would not violate the anti-cutback rules under Code Section 411(d)(6) if it was amended to eliminate or restrict a participant's ability to receive payment of accrued benefits under a particular optional form of benefit only if *both* of the following requirements were met:

1. **Single-sum distribution form required.** The 2000 final Treasury regulations required that after the plan amendment became effective with respect to the participant, the alternative forms of payment available to the participant include payment in a single-sum distribution form that was otherwise identical to the optional form of benefit that was eliminated or restricted. [Treas. Reg. § 1.411(d)-4, Q&A 2(e)(1)(i), as issued on Sept. 6, 2000 (65 Fed. Reg. 53901)]
2. **Delayed effective date of the plan amendment.** The 2000 final Treasury regulations required that the plan amendment that reduced or eliminated alternative forms of payment could not apply to a participant with respect to any distribution with an annuity starting date that was earlier than the earlier of (a) the 90th day after the date the participant had been furnished with a summary of the plan amendment that satisfied the summary of material modification requirements under Labor Regulations Section 2520.104b-3 for pension plans, or (b) the first day of the second plan year following the plan year in which the amendment was adopted. [Treas. Reg. § 1.411(d)-4, Q&A 2(e)(1)(ii), as issued on Sept. 6, 2000 (65 Fed. Reg. 53901)]

Like the new EGTRRA rules that permit certain defined contribution plan amendments that reduce or eliminate certain forms of distribution, the 2000 final Treasury regulations provided relief only from the anti-cutback rules of Code Section 411(d)(6), and not from other applicable qualification requirements, such as the survivor annuity rules of Code Sections 401(a)(11) and 417. [Treas. Reg. § 1.411(d)-4, Q&A 2(e)(3), Examples 1 and 2, as issued on Sept. 6, 2000 (65 Fed. Reg. 53901)]

By their terms, the 2000 final Treasury regulations governing permitted amendments to defined contribution plans first became effective with respect to plan amendments that were adopted on or after Sept. 6, 2000. [Treas. Reg. § 1.411(d)-4, Q&A 2(e)(4), as issued on Sept. 6, 2000 (65 Fed. Reg. 53901)] EGTRRA's provisions governing such plan amendments presumably replace the 2000 final Treasury regulations, effective with respect to plan amendments that are adopted after December 31, 2001. It is still too early to tell just how different the EGTRRA rules on plan amendments will be from the 2000 final Treasury regulations. EGTRRA's legislative history might lead one reasonably to conclude, however, that the final regulations on plan amendments that Congress directed the Treasury to issue before 2004 pursuant to EGTRRA may indeed turn out to be markedly less restrictive than the 2000 final Treasury regulations.

FINAL REGULATIONS TO BE ISSUED BEFORE 2004

Under EGTRRA, Congress directed the Secretary of the Treasury to issue final regulations, no later than December 31, 2003, that will provide that the existing prohibitions (in Code Section 411(d)(6)(B) and ERISA Section 204(g)(2)) against eliminating or reducing an accrued early retirement benefit, a retirement-type subsidy, or an optional form of benefit will *not* apply to *any* plan amendments that would eliminate or reduce early retirement benefits, retirement-type subsidies, and optional forms of benefit that create significant burdens and complexities for a plan and its participants, but only if such an amendment does not adversely affect the rights of any participant in a more than *de minimis* manner. [I.R.C. § 411(d)(6)(B), as amended by EGTRRA § 645(b)(1); ERISA § 204(g)(2), as amended by EGTRRA § 645(b)(2); EGTRRA § 645(b)(3) (regarding deadline for issuing final Treasury regulations); Statement of Managers, at 158–159]

The final regulations that the Secretary of the Treasury is required to issue before 2004 pursuant to EGTRRA would apply to plan years beginning after December 31, 2003, or such earlier date as is specified in those regulations. [EGTRRA § 645(b)(3)] Congress's directive to the Secretary of the Treasury to issue final regulations became effective on June 7, 2001, EGTRRA's enactment date.

It is intended that the factors to be considered in determining whether a plan amendment has more than a *de minimis* adverse effect on any participant will include

1. All of the participant's early retirement benefits, retirement-type subsidies, and optional forms of benefit that are reduced or eliminated by the amendment;
2. The extent to which early retirement benefits, retirement-type subsidies, and optional forms of benefit in effect with respect to a participant after the amendment's effective date provide rights that are comparable to the rights that are reduced or eliminated by the plan amendment;
3. The number of years before the participant attains normal retirement age under the plan (or early retirement age, as applicable);
4. The size of the participant's benefit that is affected by the plan amendment, in relation to the amount of the participant's compensation; and
5. The number of years before the plan amendment is effective.

[Statement of Managers, at 158.]

The provisions of EGTRRA that permit plan amendments to eliminate or reduce accrued early retirement benefits, retirement-type subsidies, and optional forms of benefit under the circumstances described above do not affect existing Code rules relating to involuntary cash-outs (under Code Section 411(a)(11)) or the survivor annuity requirements (under Code Section 417). Accordingly, if a participant is entitled to protections of the joint and survivor rules, those protections may not be eliminated by plan amendment. The intent of the EGTRRA provision authorizing final Treasury regulations is solely to permit the elimination of early retirement benefits, retirement-type subsidies, or optional forms of benefit that have no more than a *de minimis* effect on any participant but create disproportionate burdens and complexities for a plan and its participants. [Statement of Managers, at 158]

Example. The Holderness Canning Company (Holderness Canning) acquires the Squam Biological Laboratory Company (Squam Biological) and merges Squam Biological's defined benefit plan into Holderness Canning's defined benefit plan. The defined benefit plan maintained by Squam Biological before the merger provides an early retirement subsidy for individuals age 55 with a specified number of years of service. Meredith and Steve were employees of Squam Biological who transfer to Holderness Canning in connection with the merger. Meredith is 25 years old and has compensation of $40,000. The present value of Meredith's early retirement subsidy under Squam Biological's plan is $75. Steve is 50 years old and also has compensation of $40,000. The present value of Steve's early retirement subsidy under Squam Biological's plan is $10,000.

Assume that Holderness Canning's plan has an early retirement subsidy for individuals who have attained age 50 with a specified number of years of service, but the subsidy is not the same as that under Squam Biological's plan. Under Holderness Canning's plan, the present value of Steve's early retirement subsidy is $9,850. Maintenance of both subsidies after the plan merger would create burdens for the plan and complexities for the plan and its participants.

The final regulations that the Secretary of the Treasury is directed to issue before 2004 could permit Steve's early retirement subsidy under Squam Biological's plan to be eliminated entirely (even if Holderness Canning's plan did not have an early retirement subsidy). Taking into account all relevant factors, including the value of the benefit, Steve's compensation, and the number of years until Steve would be eligible to receive the subsidy, the subsidy is *de minimis*. Those Treasury regulations could also permit Steve's early retirement subsidy under Squam Biological's plan to be eliminated and to be replaced by the subsidy under Holderness Canning's plan, because the difference in the subsidies is *de minimis*. The Holderness Canning plan's subsidy could not, however, be entirely eliminated. [Statement of the Managers, at 158–159]

SUMMARY

EGTRRA significantly relaxed the anti-cutback rules under the Code and ERISA, and gave the Secretary of the Treasury broad authority to issue final regulations—by December 31, 2003—that will interpret the new rules. Until those final regulations are actually issued, plan sponsors and benefits practitioners alike have only the statutory language of EGTRRA itself and the relatively sparse legislative history that accompanied it to guide their decisions about the extent to which plan amendments and voluntary direct transfers may be used to eliminate optional forms of distribution that are associated with already-accrued benefits. Plan sponsors and benefits practitioners would welcome regulatory guidance from Treasury as soon as possible.