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Re: New Regulations Permitting Pension Plans to Eliminate Certain Benefit Options

Dear Clients and Other Friends:

On August 12, the IRS released final and proposed regulations regarding the anti-cutback rules of Code §411(d)(6). These new regulations mainly affect defined benefit pension plans with multiple benefit payment options. They should be particularly helpful to large employers that want to simplify defined benefit plan administration by eliminating benefit options inherited from predecessor plans.

Rules allowing for elimination of certain benefit options:

The final regulations (Treas. Regs. §1.411(d)-3) specify the circumstances under which a pension plan may be amended to reduce or eliminate early retirement benefits, retirement-type subsidies and optional forms of benefit. The new regulations specify two methods for reducing the number of benefit options:

- (1) Eliminating “redundant” benefit options. For this purpose, a benefit option is considered “redundant” if another option of the same type remains available. The regulations specify some “families” of options that are considered to be of the same type. For example, term certain and life options with terms 10 years or less are all considered to be in the same family so that a plan currently offering life and 10 years certain and life and five years certain could eliminate one or the other of these options.
- (2) Eliminating “noncore” benefit options where “core” options are offered. To use this approach, a plan must offer a menu of core options in categories specified by the IRS. This menu generally must include a life annuity, a 75% joint and survivor annuity, a life and 10 years certain option, and the plan’s existing option that would be most favorable for a participant with a short life expectancy (e.g. lump sum cash out).

If the benefit options that are being eliminated are more valuable or have different commencement dates than the options that will remain available, the plan sponsor must establish that the eliminated options are complex and burdensome to administer, and that the amendment does not adversely affect participants in more than a de minimis way. The regulations provide fairly specific rules for evaluating these issues.

The regulation offering the above alternatives is effective August 12, 2005. However, if a plan uses one of these methods to reduce the number of benefit options, the regulations specify a minimum period of time during which the benefit options that are being eliminated must remain available to participants.

The IRS also has proposed a “utilization test” whereby benefit options that are rarely used could be eliminated. Under this rule, a benefit could be eliminated if it was available to at least 100 participants during a relevant time period, but no participant elected it during that period. This alternative is in proposed form and may not be used until the IRS finalizes it.

Proposed Regulations Relating to Heinz Decision:

The proposed regulations address the interaction between the anti-cutback rules of Code §411(d)(6) and the nonforfeitability requirements of §411(a). This guidance is intended to reflect the Supreme Court’s holding in Central Laborers’ Pension Fund v. Heinz, 541 U.S. 739 (June 7, 2004). Heinz involved a multi-employer plan that was amended to provide that if a pensioner was reemployed by a contributing employer in a supervisory position, his pension would be suspended.¹ The Supreme Court held that adding this restriction with respect to pensions that accrued before the amendment date was a cutback that violated Code §411(d)(6).

Under the proposed regulations, plan amendments that add restrictions or conditions on the receipt of benefits accrued prior to the amendment date violate §411(d)(6). However, such amendments are permissible if they apply only to benefits accruing after the amendment.

The Heinz decision was also addressed in IRS Revenue Procedure 2005-23 issued earlier this year. Rev. Proc. 2005-23 limited the retroactive application of the Heinz decision and provides relief to plans in certain situations.

The proposed effective date of the Heinz-related regulations is June 7, 2004 (the date the Heinz decision was issued).

Conclusion:

These final and proposed regulations will help plan sponsors eliminate benefit options that are overly burdensome and are of de minimis value. The effect of these regulations is that plan sponsors with multiple benefit options may be able to simplify their plans.

If we can assist you in assuring that pension plan amendments affecting early retirement benefits, retirement-type subsidies or optional forms of benefit comply with these new requirements, please let us know.

Sincerely,

Theodore K. Rice

TKR/jks

¹ The plaintiffs were individuals who retired from bargaining unit jobs and began receiving their pensions. These individuals continued on pension after they returned to active employment in non-union supervisory positions. When the amendment in question was adopted their pensions were suspended.