

CLIENT ACTION Bulletin

Employee Benefits

Implementing Pension Benefit Restrictions

SUMMARY

For many tax-qualified single-employer defined benefit plan sponsors, the recent economic downturn has resulted in the decline in the asset value of the plans. Depending on the level of underfunding, plan sponsors may be required to restrict certain accelerated forms of benefit payments as early as April 1, 2009. If so affected, such a plan sponsor should explore options for implementing the restrictions and understand the ramifications of any decisions, as well as consider how and when to explain the changes to plan participants.

This *Client Action Bulletin* focuses primarily on concerns raised by the partial restriction on payment of accelerated forms of benefit payment, using the lump-sum form as an illustrative example. Plans facing complete restrictions on accelerated forms of benefit payments or benefit accrual freezes must consider similar issues.

DISCUSSION

Benefit Restriction Triggers: An Overview

A pension plan's funded status – the “Adjusted Funding Target Attainment Percentage” (AFTAP) – may need to be certified in order to prevent benefit restrictions as early as the first day of the fourth month of the plan year (e.g., April 1 for a calendar-year plan). If the certification is not made by that date, the AFTAP is deemed 10 percentage points lower than in the preceding year. Restrictions remain in place until the AFTAP is certified in a future plan year to be greater than the restriction threshold. In general:

- If the plan's AFTAP is certified as or is deemed to be below 60%, the plan is prohibited from paying accelerated forms of benefits.
- If the plan's AFTAP is certified as or presumed to be above 60% but below 80%, the plan is generally restricted from paying more than 50% of accelerated forms of payments.
- If the AFTAP is not certified before the first day of the tenth month of a plan year (e.g., October 1 for a calendar-year plan), the plan is presumed to have an AFTAP of less than 60% and the payment of accelerated forms of benefit payments is automatically prohibited.

Accelerated forms of payments include: (1) lump-sum payments greater than \$5,000; (2) Social Security level-income options; (3) annuity purchases; (4) the return of employee contributions; and (5) period-certain annuities with no life contingencies. The restrictions apply prospectively and thus do not affect participants already receiving benefits in accelerated forms.

Partial Benefit Restrictions on Accelerated Forms of Payment

For those plans with AFTAP certifications in the 60% - 80% range, the Pension Protection Act (PPA) and the IRS's implementing proposed regulations impose certain plan design requirements and provide options to address the partial restrictions on accelerated forms of payment. With regard to a lump-sum accelerated form of payment, such a plan may pay only half of the present value of the participant's accrued benefit (this 50% portion is referred to as the “unrestricted” benefit). A larger portion of the lump-sum may be restricted when the participant's age-65 monthly accrued benefit exceeds \$9,000.

Plan Design Requirements

If the plan's AFTAP is at least 60% but below 80%, the sponsor must adopt a plan design that gives participants the choice to receive benefit payments as follows:

- *Deferred Benefit* – The plan must permit a participant to defer his or her entire benefit (i.e., both the restricted and the unrestricted portions) to a later date when the AFTAP is 80% or more; and
- *Immediate Bifurcated Benefit* – The plan must allow the participant to bifurcate the benefit, taking the unrestricted portion as a lump sum and the restricted portion as an immediate annuity. The annuity must be payable from the trust, because an annuity purchased from an insurance company is considered an accelerated form of payment.

Plan Design Options

In cases where participants elect a bifurcated benefit, plan sponsors have two design options:

- Plans are permitted to give participants who chose to have the restricted portion paid in the form of an immediate annuity an election to convert the remaining annuity payments to a lump sum at such later time as when the plan's AFTAP has improved to 80%.
- Plans are allowed to either: require participants who elect to receive their unrestricted benefit as a lump sum to also commence the restricted portion as an annuity at the same time; or permit participants to defer the restricted portion to a later date when the AFTAP is 80% or more.

Participant Communications

Plan sponsors must notify all participants and beneficiaries of any benefit restrictions within 30 days of plan certification or of the plan being deemed underfunded. In the absence of additional guidance from the IRS, the safest route for plan sponsors is to notify all plan participants, beneficiaries, and alternate payees, even if they are not directly affected by the restriction. In general, individuals who are in pay status are not required to receive notification.

Although advance notification is not required, informing participants of possible benefit restrictions prior to the date restrictions will take effect may be prudent. This is particularly true for participants who have benefit elections in process before the effective date of the restrictions. Participants who discover that a lump sum is not available only because their election forms were received by the plan sponsor after benefit restrictions become effective are likely to be upset.

Plan sponsors will also need to redesign pension distribution election forms to reflect the plan design decisions and how those decisions relate to the plan's current distribution options. Communication of the options available to plan participants is likely to be complex, reflecting information required by law to be disclosed, such as:

- the relative value of the plan's distribution options;
- the effect of deferring (or not deferring) the commencement of benefits; and
- the volatility of future lump sum payments due to changing interest rates and the participant's increasing age.

ACTION

Plan sponsors confronting benefit restrictions face numerous challenges, particularly in the short term, as they formulate and implement strategies on plan design (and necessary plan amendments) and communications. Given the widespread declines in the financial markets from 2008, many pension funds probably experienced sufficient asset losses so as to place them in the position of restricting benefits by October 1, 2009 (or earlier, if the 2009 AFTAP is certified prior to that date). Reviewing options and planning now can help to ease some of what may be difficult changes ahead for both plan sponsors and plan participants.

For assistance in addressing issues related to implementation of benefit restrictions, please contact your Milliman consultant.

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