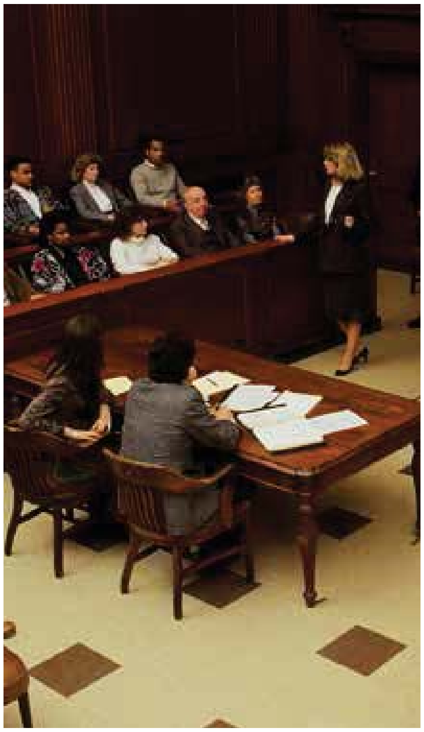
ACTUARIAL

DISTRIBUTIONS AFTER NORMAL RETIREMENT AGE: ARE YOU PREPARED?

BY JAMES E. HOLLAND, JR., MSPA, EA



What happens when a participant in a DB plan wants to retire after normal retirement age? The answers can get complicated.

There is a line from "The Happening" as sung by Diana Ross and the Supremes that has broad application to those of us working in the pension field. Heeding the warning words "it can happen to you" is a good way to prepare for an increasingly common situation and resulting question. The situation is that of a plan participant who didn't commence benefits at normal retirement age and who now requires a calculation to be made of benefits to be paid. The question is: What benefit payments should now be made to the participant? The question may be phrased in many ways, however, and care needs to be taken in providing a response, especially in the context of a defined benefit plan. Practitioners need to ask the right questions, consider the relevant provisions of law, and suggest a workable solution consistent with plan terms.

For a defined benefit plan, the situation requires careful understanding of the interaction of the law, the plan terms, and the facts pertaining to the participant. This article (together with a later article) will review the law, possible plan terms in the context of various fact patterns, and suggest solutions to the situations in a defined benefit plan. As we shall see, slight changes in plan terms or facts will result in different solutions. Thus, there will be a need to ask questions to clarify the facts for a particular inquiry. At a minimum, practitioners should understand the reasons and possible issues with each solution. The articles will focus on the annuity benefit that would need to be provided and will avoid discussion of rollover treatment.

It's helpful to categorize the situations by when the participant terminated employment. The use of categories enables the discussion and analysis to move from the relatively easier situations to the more complex ones. Also, the categories will provide a framework for thinking about and raising questions of an actual situation. No claim is made that any situation is simply "easy." The categories used in the articles are:

- Termination of employment before attainment of normal retirement age
- Termination of employment on or after attainment of normal retirement age but *before* the April 1 following attainment of age 70 ½
- Termination of employment on or after attainment of normal retirement age *and* on or after the April 1 following attainment of age 70 ½

Under each category, there are variations in plan terms and participant facts that will affect the answer or answers provided. While the above categories are the most common ones in an actual situation, there will be special situations that don't fit into one of the three categories. However, the analysis used for the three categories should enable you to address the special situations. Before the analysis can be started we need to review the law and the possible plan terms that might apply under the law.

LAW REVIEW

This section will briefly review the relevant provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended, and the plan qualification requirements of the Internal Revenue Code (Code) as they apply to:

- Nonforfeiture rules for plan benefits
- Accruals and adjustments to plan benefits after attainment of normal retirement age
- The required commencement date for plan benefits
- Payment of benefits following the attainment of age 70 ½
- Section 415 and section 436 limitations
- Requirements of the Employee Plans Compliance Resolution System (EPCRS) program

Keep in mind the general qualification requirement that a plan must be administered in accordance with its terms. Typically, the situations encountered will be ones where the plan terms couldn't be timely applied. Therefore, the answer to the question of what benefits are to be paid is also an answer to what corrective action needs to be taken.

NONFORFEITURE RULES

Benefits must become nonforfeitable upon attainment of the normal retirement age. Prior to normal retirement age, benefits must become nonforfeitable following one of two prescribed schedules. The normal retirement age is defined as the earlier of the age specified under the plan, or the later of age 65 or the 5th anniversary of the commencement of participation in the plan.[1] Benefits may be "suspended" (forfeited) if the participant continues in "section 203(a)(3)(B) service" after attainment of normal retirement age if the plan so provides and appropriate notice is provided.[2]

In Revenue Ruling 81-140, the IRS analyzed the application of the suspension of benefit rules of ERISA section 203(a)(3)(B) to a number of situations. In particular, situation one pertained to a participant who continued working past normal retirement age. Absent a proper suspension notice, the revenue ruling held that the plan was required to actuarially increase the benefits to prevent a prohibited forfeiture of benefits.

More recently, the 7th Circuit Court of Appeals appears to have agreed with the characterization of the nonforfeiture rules taken by the IRS. (See *Contilli v. Teamsters Local 705 Pension Fund, 46 EBC 1590, 7th Cir. 2009.*) The Court received a brief as *amicus curiae* from the United States[3] and followed the brief in holding that an actuarial increase was required for a contested period after normal retirement age.[4]

Accruals After Normal Retirement Age

A plan may not provide for the reduction (or cessation) of the accrual of benefits upon the attainment of normal retirement age (or any other age).[5] A plan is permitted to provide

[1] See Code section 411(a).

[2] See Code section 411(a)(3)(B), ERISA section 203(a)(3)(B), and Department of Labor (DOL) regulation section 2530.203-3(c).

[3] The Department of Justice filed the brief on behalf of the United States presumably after consultation with the DOL and IRS. ASPPA members may find the brief at www.asppa.org.

[4] The brief gives a review of the legal authorities and also notes that increases for part of the period appeared not to be within the scope of what the Court needed to decide. (See footnote 3 of the brief.)

that the accrual of benefits that might otherwise occur is reduced to the extent of any actuarial increase in benefits or of benefit payments made. The application of these provisions must comply with regulations. Proposed IRS regulations were issued in 1988 and the IRS stated that the proposed regulations may be relied upon pending final regulations (which have not yet been issued).[6]

Required Commencement of Benefits
A plan is required to provide that a participant's benefits commence not later than the 60th day after the close of the plan year in which the latest of the following events occurs:

(1) The attainment of age 65, or, if earlier, the normal retirement age specified under the plan;

(2) The 10th anniversary of the date on which participation commenced in the plan; or

(3) The date specified by an election made by the participant.

However, a plan may require that a participant file a claim for benefits before the payment of benefits will commence.[7]

Benefits Payable After Age 70 ½
Code section 401(a)(9) requires that a plan provide that benefits commence not later than the *required beginning date*. For a participant who is not a 5 percent owner, the required beginning date is the later of the April 1 following the calendar year of attainment of age 70 ½ or the April 1 following the calendar year in which the participant retires. For a 5 percent owner, the required beginning date is the April 1 following the calendar year of attainment of age 70 ½. Under the IRS regulations, a plan is permitted to provide that the required beginning date for all participants is the April 1 following the calendar year of attainment of age 70 ½.[8]

Code section 401(a)(9) and the IRS regulations provide that benefits must be actuarially increased from the April 1 following the calendar year of attainment of age 70 ½ until the time that the participant retires to account for the time when the participant isn't receiving benefits. If a plan provides a uniform required beginning date of the April 1 following the calendar year of attainment of age 70 ½ for all participants, and actually makes distributions in an amount to satisfy section 401(a)(9), no actuarial increase is required under those regulations.[9]

The IRS regulations further provide that the actuarial increase is such that, at the end of the period for the increase, the retirement benefits payable to a participant must be no less than the actuarial equivalent of retirement benefits that would have been payable as of the date the actuarial increase must commence under paragraph (a) of Q&A-7 if benefits had commenced on that date; *plus* the actuarial equivalent of any additional benefits accrued after that date; *reduced* by the actuarial equivalent of any distributions made to the employee's retirement benefits after that date. Actuarial equivalence is determined using the plan's assumptions for determining actuarial equivalence for purposes of satisfying section 411.[10] The IRS regulations require that the actuarial increase under Code section 401(a)(9) be provided even for periods for which benefits can otherwise be suspended.[11]

Sections 415 and 436
Code section 415 provides limitations on benefits under a qualified DB plan. The current regulations were issued in 2007. In general, the limitations of section 415 are the lesser of a dollar amount and 100 percent of average compensation. The key aspect of section 415 for these articles is that the dollar limitation may be adjusted for benefit commencement after age 65, but the 100 percent of average compensation limitation isn't adjusted for the age when benefits commence.

Code section 436 restricts unpredictable contingent event benefits, plan amendments, certain distributions, or accrual of benefit for an underfunded plan, depending on the degree of the underfunding. The key aspect of section 436 for these articles is that a lump-sum payment of accumulated missed payments (with interest) may be restricted if the plan is underfunded.[12]

EPCRS
EPCRS provides a system for correcting plans that haven't met the Code's qualification requirements. Revenue Procedure 2008-50 contains the current provisions of EPCRS. Two provisions of EPCRS should be considered as part of the analysis of a particular situation. First, the general principle that a correction method should restore the plan to the position it would have been in had the failure not occurred (including the restoration of participants' benefits). Second, corrective distributions

[5] See Code section 411(b)(1)(H).
[6] See proposed IRS regulation 1.411(b)-2(b)(4).
[7] See Code section 401(a)(14) and IRS regulation 1.401(a)-14.
[8] See IRS regulation 1.401(a)(9)-2 Q&A-2(e).
[9] See IRS regulation 1.401(a)(9)-6 Q&A-7.
[10] See IRS regulation 1.401(a)(9)-6 Q&A-8.
[11] See IRS regulation 1.401(a)(9)-6 Q&A-9.
[12] It is not clear as to whether "corrective" payments for late commencement would or would not be subject to the restrictions of section 436. However, in responding to questions for the enrolled actuaries meeting in 2011 and published in the "Gray Book," the IRS took the view that a lump sum payment of retroactive benefits pursuant to a retroactive annuity starting date is potentially subject to the restrictions. (See Q&A-32.)

should be increased to account for the delayed payment, consistent with the plan's actuarial adjustments.

PLAN PROVISIONS

The plan terms will usually define the normal retirement age, specify when benefits commence, provide whether there is a suspension of benefits (and under what circumstances) for continued employment, and specify what happens after age 70 ½. Preferably, the plan terms are clear but when they're not, care needs to be taken to ascertain the interpretation of ambiguous provisions. The variations are myriad. For example, a plan may provide that the normal retirement age is age 65. Or, the plan may provide that the normal retirement age is the later of age 65, or the 5th anniversary of the commencement of participation. An age earlier than age 65 may be specified. Therefore, the variation in plan terms will be covered later as we review the situations under each category.

APPROACH TO SITUATIONS

The remainder of Part I will look at various factual situations that can apply under the first category. One or more solutions to each situation will be provided with some reasoning and problems that might arise. The solutions look to accomplish the following:

1. Comply with plan terms to the extent possible;
2. Avoid any prohibited forfeiture of benefits;
3. Satisfy the qualification requirements including sections 401(a)(9), 415, and 436; and
4. Be consistent with the correction rules set forth in Revenue Procedure 2008-50.

Part II will look at factual situations in the other categories as well as some special situations. It will conclude with some suggestions for approaching any question that might arise. Last, Part II will include a table summarizing the situations and the solutions.

TERMINATION ON OR BEFORE NORMAL RETIREMENT AGE

In each of these situations, the participant terminated covered employment before reaching normal retirement age, has a vested benefit, isn't working in any employment for which a suspension of benefits could apply, and now (after normal retirement age) wants to commence benefits. The situations differ with respect to plan terms and to when (after normal retirement age) the participant requests benefits. This category is relatively easy, because the suspension of benefit rules (and related questions and issues) don't need to be considered.

For each situation, the participant's facts will be provided along with relevant plan terms. A solution and an explanation will be suggested. In all of the situations a normal retirement age of 65 and a normal retirement benefit of $1,000 per month will be used. The interest rate for actuarial equivalence will be 6 percent and the interest rate for accumulating missed payments will be 3 percent.[13]

Situation 1

The participant hasn't reached age 70 ½ and now wants to start benefits at age 67. The plan says that benefits are to commence at normal retirement age. Here the solution is to provide the missed payments with interest. This would be a payment of $24,754.06 with payments of $1,000 thereafter. The payment of $24,654.06 avoids a forfeiture of benefits and is consistent with plan terms that say benefits are to commence at normal retirement age. Note there may be a potential issue if section 436 would restrict the ability to make the payment. In that case, consider filing under EPCRS to get the correction blessed by the IRS.

An alternative, actuarially increasing the benefit from normal retirement age, would avoid the forfeiture but would *not be* consistent with plan terms, so this alternative may not be the best solution for this situation. The amount under this alternative would be a payment of $1,203.08. Also, if the increased benefit would exceed a limitation of section 415 (and can exceed the 100 percent of average compensation limit even for an employee who isn't highly compensated) then the solution would cause a different plan qualification issue. Accordingly, if this alternative was used, a filing under EPCRS might be best.

Situation 2

The participant hasn't reached age 70 ½ and now wants to start benefits at age 67. The plan says that benefits are to commence when application is made. If the plan says that payments are made retroactively to normal retirement age, the solution to situation 1 would apply. One can argue that the retroactive payments are appropriate, especially if the plan failed to provide timely summary plan descriptions, annual funding notices, and other communications that a participant should receive.

But if the plan is silent on what happens if application is made after normal retirement age (or explicitly calls for an actuarial increase), then the solution would be to actuarially increase the benefits from normal retirement age to the date of benefit commencement.[14] The increase would be to $1,203.08 (the alternative solution in situation 1). One potential problem with the increase is that the 415 limitations could be exceeded.

[13] Accumulation will be at interest only and actuarial equivalence will use both mortality and interest. The mortality table used is the unisex mortality table specified by the IRS for determining lump sum benefits under Code section 417(e) for 2012.

[14] This article will adopt the view that there cannot be a forfeiture of benefits merely on account of applying after the normal retirement age. If that view is taken, legal counsel should be consulted in as much as it is likely there will be a dispute.

If the actuarial increase would cause a violation of section 415, the solution needs to be revised. The revision would be to actuarially increase benefits to the point that the section 415 limit is reached, and then pay the "missed" payments with interest from that point to the benefit commencement date that would otherwise have been used. In effect, the revised solution would be treating benefits as commencing at an earlier point (but still after normal retirement age). Of course, there is a potential section 436 issue with respect to accumulating the payments with interest, which should lead to consideration of an EPCRS filing.

Situation 3

The participant has passed the April 1 following attainment of age 70 ½ and now wants to start benefits at age 72. The plan states that benefits are to commence at normal retirement age. The plan also states that, if benefits commence after the April 1 following the calendar year of attainment of age 70 ½, the benefits are actuarially increased from that April 1 to the date of commencement. The participant was age 71 at the April 1 following attainment of age 70 ½. There are two readily apparent solutions to this situation.

The first solution is simply to pay the missed benefits from normal retirement age with interest as was done in situation 1. The amount of the payment would be $93,436.98. This solution avoids a forfeiture of benefits, but has potential section 436 issues. Also, this solution ignores the plan terms calling for the actuarial increase after the April 1 following attainment of age 70 ½.

A second solution is to pay the missed benefits from normal retirement age to the April 1 following attainment of age 70 ½ with interest, and actuarially increase the benefits from that April 1 to the date annuity payments would start. The amount of the payment is $81,242.86 for missed payments and an actuarially increased amount of $1,113.72. This solution avoids a forfeiture of benefits and gives effect to the plan wording about actuarial increases after age 70 ½, but may raise potential section 436 and section 415 issues (for the reasons explained in situations 1 and 2). Also, the April 1 date is likely the required beginning date for this employee, so there would be a section 401(a)(9) issue as well.[15]

Because each solution has its issues, consideration should be given to an EPCRS filing in this situation.

Situation 4

The participant has passed the April 1 following attainment of age 70 ½ and now wants to start benefits at age 72. The plan states that benefits are to commence when application is made. The plan also states that, if benefits commence after the April 1 following the calendar year of attainment of age 70 ½, the benefits are actuarially increased from that April 1 to the date of commencement.

The first solution is to actuarially increase the benefits from normal retirement age to the commencement date. This avoids a forfeiture and comports with the plan language for increases after age 70 ½. The actuarially increased benefit would be $1,999.43. However, the April 1 following attainment of age 70 ½ is the required beginning date for this fact pattern, and the plan presumably calls for benefits to commence. Accordingly, we need to consider a second solution.

The second solution is to actuarially increase the benefits from normal retirement age to the required beginning date and then to pay the missed payment from that April 1 with interest. Future payments would continue in the amount payable at the April 1. The actuarially increased amount from normal retirement age to the age at the April 1 following attainment of age 70 ½ is $1,795.27, and the accumulated value of the missed payments is $21,891.70. While this solution gives effect to the required beginning date under the plan, it doesn't account for the actuarial increase language for commencement.

Given the plan provisions, there is a third solution that reflects all of the plan terms to some degree. The benefit is actuarially increased to the April 1 following attainment of age 70 ½. The payments are accumulated with interest and paid to the participant. This payment is the $21,891.70. The April 1 benefit is actuarially increased to the benefit commencement date (which is $1,999.43) and offset by the equivalent of the accumulated amount paid to the participant (which is $199.00). The resulting actuarially increased benefit is $1,800.44. Of course, as with the other situations, there may be issues with the compensation limit of section 415 or the restrictions of section 436 in using the third solution.

The common thread for these situations was that termination took place before the attainment of normal retirement age and there was no service that would give rise to a suspension of benefits. Part II will consider situations arising under the second and third category as well as some situations not covered by the categories. PC

James E. Holland, Jr. is chief research actuary for Cheiron in McLean, Va.

[15] That would be the case here because the participant is not employed in covered employment under the plan.