



Workshop 35 Benefit Restrictions

Richard A. Block, ASA, FSPA, MAAA,
Block Consulting Actuaries, Inc., El Segundo, CA

Thomas J. Finnegan, MSPA, CPC, QPA, MAAA, FCA,
Principal, The Savitz Organization, Philadelphia, PA

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What We are Covering

- Rules limiting payments to “top 25” HCEs
- PPA rules limiting accelerated payments
- PPA rules limiting ongoing accrual of benefits
- PPA rules limiting amendments increasing benefits

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Two levels of Restrictions

- §401(a)(4): Prevents discrimination in favor of HCEs by preventing them from stripping lump sums from “underfunded” plans
- PPA restrictions: Improves funding of the plan by restricting lump sums and prohibiting benefit increases for certain underfunded plans

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Treas. Reg. §1.401(a)(4)-5(b) Top 25 Restrictions



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Treas. Reg. §1.401(a)(4)-5(b)

- Restricted employees are HCEs or HCFEs
- It's a required provision in a defined benefit plan document
 - Question: Can plan say that these rules are not applicable if plan covers only HCEs?
- Restriction of benefits upon plan termination.

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Treas. Reg. §1.401(a)(4)-5(b)

- Accelerated distributions cannot be made to HCEs unless after taking into account the amount of the distribution for the restricted employee.... the value of plan assets must equal or exceed 110% of current liabilities
- These restrictions are the most common restrictions today – they hit first

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Definition of a Restricted Employee

- HCE or former HCE
- One of the 25 *nonexcludable* employees or former employees with the largest amount of compensation in the current or any prior year.
 - Plan can elect greater number than 25
- Should be defined in the plan document

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Definition of a Restricted Employee

- Determined on a controlled group basis
- Definition of pay: use §415(c)(3) pay on a consistent basis
- Re-determine the list each year
- IRS regulations provide anti-cutback relief for plan amendments that alter the restricted group
- If a restricted HCE received a distribution in the past, is he/she still counted?

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Determination of HCE

- What does the plan document say?
 - Use of top-paid group?
 - Use of calendar-year data election?
- Thresholds before 1987
 - \$75,000 in lookback year
 - \$50,000 (and in top-paid group) in lookback year

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Determination of HCFE

- Performed no service during determination year
- Treated as HCFE if:
 - Had a separation year before determination year
 - Was a highly compensated active employee in the separation year or in any determination year ending on or after employee's 55th birthday

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Example 1

- Art, age 44, is an HCE for the plan year ended 12/31/09 (he earned \$150,000 in 2012)
- Art earns \$50,000 in 2013, so not an HCE for 2014
- Art terminates employment in 2014
- Question: Is Art a restricted employee?
 - Even if Art was one of the top 25, he was not an HCE in his year of termination and was not an HCE after age 55
 - Art is NOT an active HCE nor is he an HCFE, so he cannot be a restricted employee

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Example 1

- What if Art was 60? What if Art terminated in 2013? Or both?
 - In either case Art would qualify as an HCFE and a potential restricted employee
 - If he was 60, he would have been an HCE in a determination year ending on or after his 55th birthday
 - If he terminated in 2013, he would have been an HCE in the year of his termination

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Example 1: Solution

- Once you determine that Art is an HCFE, you must determine if he is one of the top 25
- List all highly compensated employees for the years 1995 (the year the business started) - 2010
- Arrange list in order of compensation, using the highest compensation earned by each HCE
- Art is number 30 on the list and is, therefore, not a restricted employee

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Restrictions on Distributions

- If a plan is not adequately funded, cannot pay to a restricted employees
 - More than a straight life annuity that is the actuarial equivalent of the accrued benefit
 - If the total PVAB (lump sum?) for the HCE is less than 1% of current liability, no restriction applies
 - Plus a Social Security supplement (if the restricted employee is entitled to receive one)

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Benefits for Purposes of Restriction

- Lump sum distributions
- Loans in excess of §72(p)
- Any periodic income
- Death benefits not provided by insurance
- QDROs

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Current Liability and Plan Assets

- “...any reasonable and consistent method may be used in determining the value of plan assets and current liabilities.” 1.401(a)(4)-5(b)(3)(v)
- Plan Assets:
 - No guidance as to whether actuarial or market value of assets should be used
 - Can a receivable contribution be included in the assets?

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Current Liability and Plan Assets

- Consistency-
 - Methodology must be consistent for purposes of determinations within the same plan year
 - But can change from year to year
 - As long as the change does not act to discriminate in favor of HCEs and HCFEs
 - Gray Book 2005 – 32

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Definition of Current Liability 2008 Plan Years and Later

- “Current Liability” is not defined for 2008+ plan years
 - IRS has suggested that you may:
 - Substitute “target liability” for current liability; *or*
 - Continue to use current liability on pre-PPA basis
- [EA Meeting 2008 Gray Book Update, Q&A 30]*
- Do this calculation annually or update to reflect additional accruals during the year?

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Definition of Current Liability MAP-21 and HATFA

- Does the ability to substitute target liability extend to the funding target calculated under MAP-21 or HATFA?
 - Gray Book 2013-8 provides that the use of the MAP-21 rates for this purpose would be a reasonable method for determining current liability
 - 2015 Gray Book Q 22 provides similar guidance with respect to HATFA rates for plans already using MAP-21

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Definition of Current Liability

- What Does The Plan Document Say?
 - If your plan provides that “current liability” is determined using any method that complies with 1.401(a)(4)-5(b)(3)(v), the plan may use any allowable method without amendment
 - However some plans reference Current Liability as defined in Section 412(l)(7) of the Code or other specific reference
 - which would force the use of the old CL definition absent an amendment
 - Some plans have amended to replace current liability with target liability or funding target under Section 430,
 - which would force you to use whatever you used for funding

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Security Arrangements (Participant Action)

- Deposit funds equal to 125% of the restricted amount in an escrow account (IRA or personal account)
- Post a bond equal to 100% of the restricted amount
 - (can't find anyone to do this)
- Purchase a bank letter of credit equal to 100% of the restricted amount

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Security Arrangements

- Restricted Amount Must be Recomputed Each Year (if collateral agreement is used or other security is provided)
- During a plan year, the amount that may be required to be repaid to the plan is the restricted amount

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Security Arrangements

- Restricted amount is the excess of:
 - The accumulated amount of distributions made to the employee during the period of restriction, over
 - The accumulated amount of the unrestricted limit during the restriction period

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Releasing of Security

- Security can be released if:
 - Participant drops off high-25 list
 - Plan becomes 110% funded
- Coordination with IRA Trustee

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What happens if Restricted Lump Sums are Paid?

- Violation of plan terms
- Disqualifying defect

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What Happens if Restricted Lump Sums are Paid?

- Seek a collateral agreement or other security agreement from recipient
- Ask for the money back
- VCP
- Contribute enough to get the plan assets up to 110% (measured after the distribution)
 - Timing determines if VCP is needed

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What Happens When a Shareholder Leaves and a Plan is Insufficient?

- Assume that plan is not covered by PBGC:
 - Terminate the plan
 - Pay full benefits to NHCEs
 - Pay shareholders to extent funded
 - Start a new plan

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What Happens When a Shareholder Leaves and a Plan is Insufficient?

- Assume that plan is covered by PBGC:
 - Will need to continue the plan
 - Are there majority owners?
 - Will majority owners forgo benefits to allow termination?

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PPA BENEFIT RESTRICTIONS

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PPA Benefit Restrictions

- PPA restricts distributions and benefit accruals to plan participants from plans that are not fully funded to the amount of the participant's monthly life annuity
- Effective for plan years beginning after 2007

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PPA Benefit Restrictions

- PPA also requires the freezing of benefits under certain circumstances
- The degree of restriction depends on the level of funding for the defined benefit plan
- Applicable to:
 - Benefit increases
 - Available benefit forms
 - Benefit accruals
 - Shutdown benefits

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Restrictions Based on AFTAP

- Normally an AFTAP is:
 - Assets – COB – PFB + NHCE Annuities
 - Funding Target + NHCE Annuities
- For purposes of the presentation, AFTAP includes presumed AFTAPs and inclusive presumed AFTAPs
- Its simple
 - The better funded the plan, the fewer restrictions apply
- In remaining slides if it is noted that a plan is 60% funded or something similar, take that to mean “the plan has an AFTAP of 60%”, unless noted otherwise

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Various Types of Restrictions

- 436(b) limits plant shutdown benefits
 - for plans less than 60% funded
- 436(c) limits amendments increasing benefits
 - for plans less than 80% funded
- 436(d) limits payment of accelerated distributions
 - for plans less than 80% funded (full lump sums)
 - for plans less than 60% funded (partial lump sums)
- 436(e) freezes future benefit accruals
 - for plans less than 60% funded

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Various Types of Restrictions: Exception

- ▶ Exception to 436(d) limitation on lump sum distributions
 - ▶ Applicable to a plan frozen on or before 9/1/05

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c) Limit –Amendments Increasing Benefits

- Any amendment increasing benefits, establishing new benefits, changing the existing accrual rate or changing vesting schedule
- Exception for flat dollar plans
- IRS view is that COLA increases under 415(b) and 401(a)(17) are “benefit increases”
 - but mandatory vesting changes are not

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c) Limit – Amendment Increasing Benefits

- Increase in 415 Limit is deemed to be a plan amendment
- If AFTAP < 80%, plan sponsor may elect not to make 436 contribution to cover cost of amendment
- If AFTAP later increases to >80%, plan sponsor would need to retroactively pay benefits up to 415 limits (unless automatic COLA is removed from plan)

[2009 EA Meeting Gray Book, #20]

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c) Limit –Amendment Increasing Benefits

- What about an increase in lump sum benefit due to the annual update to the applicable mortality table?
- Is it a deemed amendment for 436(c) purposes?
- No!

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C) Limit – Amendment Increasing Benefits

- Plan sponsor wants to provide an early retirement window
- Current AFTAP is 70%
- Increase in funding target is based on assumed utilization

[2009 EA Meeting Gray Book, #22]

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c) Limit – Mid-Year Amendment: 3 Possibilities

1. AFTAP is > 80% after amendment
 2. AFTAP is > 80% before amendment and < 80% after amendment AND plan sponsor makes a 436 contribution to bring AFTAP up to 80%
 3. AFTAP is < 80% before amendment AND plan sponsor makes a 436 contribution to fully fund the amendment
 - Not the amount to bring to 80% after the amendment
- Note: A 436 contribution cannot be used for 430 purposes

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How do amendment restrictions apply?

- You know that a plan that is less than 80% funded cannot adopt an amendment increasing past benefits...
 - But what if they do it anyway?
 - No 436 contribution
 - No bond or other surety instrument

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How do amendment restrictions apply?

- Most common occurrence
 - Each year the 415 limit and 401(a)(17) limit increase
 - The IRS considers this an amendment(s) and, at least the 415 portion is an amendment increasing benefits for 436 purposes
 - In this “amendment”, the 415 adjustment increases both past and future service benefits and the 401(a)(17) adjustment increases only future service benefits

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How do amendment restrictions apply?

- Most common occurrence
 - Assume the plan is less than 80% funded.
 - Absent a 436 contribution, the amendment can't take effect
 - What is the “amendment”?
 - Is it the 415 change or is it both the 415 change and the 401(a)(17) change?
 - » Are they considered separately?
 - Do we ignore only the effect on past service or the effect on past and future service?

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How do amendment restrictions apply?

- Consider another amendment, benefit formula is changed from 1% of pay to 2% of pay for all years of service.
- AFTAP is less than 80% and no 436 contribution was made
- The amendment did not mention the possibility of a 436 restriction on its implementation nor did it make any contingencies for that occurrence

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How do amendment restrictions apply?

- Those who thought 415 and 401(a)(17) were separate amendments, are the past service change to 2% and the future service change to 2% separate amendments?
- Is the future rate of benefit accrual 1% or 2%?
- What if past and future accrual rates were in separate paragraphs of the amendment?
- What if another paragraph of amendment added a 10 C&L, benefit option (and had no impact on funding target), would that take effect?

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How do amendment restrictions apply?

- When the restriction lifts, do we recognize the amendment?
- Or since the amendment could not go into effect on its proposed effective date is it forever void?
- Is there a sunset date for the amendment such that, if the amendment can't go into effect by that date, it never take effect?

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How do amendment restrictions apply?

- 1.436-1(a)(4)(iv) Treatment of plan amendments that do not take effect.
 - If a plan amendment does not take effect as of the effective date of the amendment because of the limitations of section 436(c) and paragraph (c) of this section,
 - But is permitted to take effect later in the plan year as a result of additional contributions under paragraph (f)(2) of this section
 - or pursuant to the enrolled actuary's certification of the adjusted funding target attainment percentage for the plan year that meets the requirements of paragraph (g)(5)(ii)(C) of this section

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How do amendment restrictions apply?

- 1.436-1(a)(4)(iv) Treatment of plan amendments that do not take effect.
 - then the plan amendment must automatically take effect as of the first day of the plan year (or, if later, the original effective date of the amendment).
 - If the plan amendment cannot take effect during the plan year, then it must be treated as if it were never adopted, unless the plan amendment provides otherwise.

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How do lump sum restrictions apply?

- AFTAP Under 60%
- AFTAP between 60% and 80%

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How do lump sum restrictions apply?

- **Under 60%**
- If a plan's AFTAP is less than 60%, it may not make distributions greater than the amount payable as a life annuity
- If the employer is in bankruptcy and less than 100% funded, it may not make distributions greater than the life annuity amount
- The plan may not purchase annuities during this restriction

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How do lump sum restrictions apply?

- **Under 60%**
 - Restriction applies to benefit with an ASD on or after the applicable 436 measurement date
 - Note 436 ASD is different than 415 ASD
 - Plan is required to provide that each affected participant / beneficiary who requests a prohibited form be allowed to choose to
 - Elect another form or
 - Defer payment to a later date
 - Later date cannot cause a failure of other qualification requirements, such as 401(a)(9)

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How do lump sum restrictions apply?

- **At least 60% but less than 80%**
 - If a plan's AFTAP is between 60% and 80%, the plan is restricted in making accelerated payments in excess of a life annuity

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How do lump sum restrictions apply?

- **At least 60% but less than 80%**
 - A plan which otherwise provided accelerated payments is required to offer
 - A one-time payment of the non-restricted portion of the benefit, to each participant entitled to receive a prohibited payment during a restricted period, equal to the lesser of:
 - The PV of the maximum PBGC Guaranteed Benefit (<http://pbgc.gov/prac/mortality-retirement-and-pv-max-guarantee/present-guarantee.html>)
 - One-half of the payment that could be made absent the restriction

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How do lump sum restrictions apply?

- **At least 60% but less than 80%**
 - Further the plan is required to allow the participant to elect another form with respect to the restricted portion of his benefit.
 - Finally, the plan is required to allow the participant to defer commencement of his benefit to a later date, subject to the qualification rules ((401(a)(9)...)
 - The plan MAY, but need not, allow the participant to defer the restricted portion and receive the non-restricted immediately

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How do lump sum restrictions apply?

- Let's assume the participant elects the first option, (Half lump sum and immediate annuity) being told that he can switch from the annuity to his residual lump sum when the restrictions lift
- What happens at "unrestriction" ?
 - Does he automatically shift to lump sum on annuity portion?
 - Does he have the right to elect to convert?
 - What are the plan's obligations?

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How do lump sum restrictions apply?

- Does he automatically shift to lump sum on annuity portion?
 - It may depend on the plan language and the language of the QJSA notice
 - It isn't clear that at the original ASD the QJSA notice could contain sufficient information to properly describe the benefit to be paid at a later date, if at all, or to properly determine the relative value of such benefit
 - Likely cannot automatically shift, he may be given the opportunity to re-elect when restrictions lift however. Is 2015-49 a problem?

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How do lump sum restrictions apply?

- Does he have the right to elect to convert?
 - Again plan and election form language will control. The plan can contain a provision that allows those restricted under 436 to elect to re-elect their benefit once the restrictions lift.
 - Alternatively, once the restrictions lift, the employer can offer this opportunity to the formerly restricted retirees (BeRF, 401(a)(9) and ADEA issues perhaps)
 - The first option is cleaner but leads to...

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How do lump sum restrictions apply?

- What are the plan's obligations?
 - It seems that Option 1 leads to a positive obligation on the part of the Plan Administrator to inform restricted retirees once the restrictions are lifted.
 - Notice 2012-46 provided no corollary to the 101(j) notice for the lifting of a restriction except under the third option
 - If the participant is able to use a single ASD and automatically convert to a lump sum upon lifting the restriction, participant has an enforceable plan right to the lump sum

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How do lump sum restrictions apply?

- What are the plan’s obligations?
 - Under Option 3, the participant received the unrestricted portion and deferred the restricted portion
 - Notice 2012-46 creates a special 101(j) notice that must be given to these participants upon the lifting of restrictions allowing the participant to commence the remainder

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How do lump sum restrictions apply?

- What are the plan’s obligations?
 - Similarly, if the participant has the right under the terms of the plan to convert upon lifting restrictions, the Plan Administrator MUST inform the affected retirees of their rights.
 - Interestingly, the single ASD/single election has long been used in the case of “High 25” restrictions
 - HCE makes a single election to receive the amount that would be payable as a life annuity until restriction lifts, then gets lump sum

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How do lump sum restrictions apply?

- What are the plan’s obligations?
 - Somehow, the top-25 guys generally are timely informed of the release of restrictions, not clear that 436 participants will be

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How are missed accruals handled?

- Two Basic methods
 - Auto reinstate
 - Non auto reinstate
- Variations
 - No reinstatement?!? No resumption!!!
 - Amendment during 436 freeze

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How are missed accruals handled?

- Auto reinstate
 - Once the plan exceeds the 60% threshold, plan benefit accruals not only resume, but are reinstated retroactively to original 436 freeze.
 - If freeze less than 12 months in duration, plan reinstatement of benefits is not treated as an amendment increasing benefits

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How are missed accruals handled?

- Auto reinstate
 - If freeze exceeds 12 months, reinstatement of lost accruals is an amendment increasing benefits
 - if plan not 80% funded before reinstatement, whole cost of past service reinstatement would have to be paid for with a 436 contribution

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How are missed accruals handled?

- No reinstatement?!? No resumption!!!
 - If plan becomes adequately funded before 204(h) period runs, is the plan provision ignored?
 - Does the 204(h) notice have to be given in advance of the AFTAP certification or in advance of the date accruals would have resumed?

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How are missed accruals handled?

- No auto reinstate-
 - Benefit accruals for the freeze period are lost
 - When restriction lifts, benefit accruals resume, with no adjustment for past benefit
 - Regardless of length of freeze, if employer wishes to restore lost accrual, formal amendment is necessary, subject to 80% AFTAP restrictions
 - Grey book has detailed examples on reinstatements for unit accruals etc.,
 - No guidance on how this works for fractional rule and there appear to be issues.

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How are missed accruals handled?

- No reinstatement?!? No resumption!!!
 - Not specifically addressed in regulations,
 - Some plans have written provisions such that if a benefit accrual freeze occurs under Section 436, the freeze in benefit accruals is permanent
 - Variations include that the freeze is permanent in the case of a certified AFTAP of less than 60% but not based on a presumption

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How are missed accruals handled?

- No reinstatement?!? No resumption!!!
 - While the 101(j) Notice generally covers the accrual freeze in a normal 436 freeze situation, this plan provision appears to require an actual 204(h) notice
 - Some argue that since its not an amendment at the time of the freeze, there is no need for 204(h)
 - 204(h) Notice requires 15 day or 45 day notice to participants before effective date of significant reduction in benefit accrual

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How are missed accruals handled?

- No reinstatement?!? No resumption!!!
 - If plan becomes adequately funded before 204(h) period runs, is the plan provision ignored?
 - Does the 204(h) notice have to be given in advance of the AFTAP certification or in advance of the date accruals would have resumed?

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How are missed accruals handled?

- Plan amended during freeze
 - Assume plan has language providing for automatic reinstatement of accruals, if freeze last less than 12 months
 - During the plan freeze and after each participant had completed enough freeze service to earn an additional benefit (had the freeze not been in place), employer elects to amend the plan to eliminate the reinstatement of lost accruals

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How are missed accruals handled?

- Plan amended during freeze
 - Can the employer do this?
 - Is there a 411(d)(6) issue given that employees had already completed enough service to accrue additional benefits?
 - What hoops must the employer jump through to make this work?
- Notice 2012-46 provides an example that illustrates this is not only possible but details that the 204(h) requirement would only apply at the time the formal freeze amendment adopted

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How are missed accruals handled?

- Funding issues
 - Actuary required to ignore funding restrictions expected to apply to the current year for purposes of valuation
 - For reinstatement plan, valuation should recognize all benefits to be reinstated, assuming freeze has lasted less than twelve months
 - After two years ignore lost accruals but assume restriction lifted for future accruals

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How are missed accruals handled?

- Funding issues
 - For 12 month re-instatement plans, until the 12 months have passed, assume no effect of restriction
 - For non-reinstatement plan and plans which re-instate beyond 12 months, ignore past accruals which have been lost, assume future accruals, including current year will occur
 - For non-resumption plan, the freeze is permanent, do not assume current accruals will occur

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