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Plan Sponsor Basics

Webinar 2 of 6

Funding-Based Restrictions on Single-Employer Defined Benefit Plans

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Introduction

- Section 436 restricts benefit payments, benefit increases, and benefit accruals under single - employer defined benefit plans based on plan underfunding and plan sponsor bankruptcy.
  - AFTAP < 100% and plan sponsor in Chapter 11
    - *100% restriction on accelerated benefit distributions*
  - 60% ≤ AFTAP < 80%
    - *50% restriction on accelerated benefit distributions*
    - *No amendments increasing benefits*
  - AFTAP < 60%
    - *100% restriction on accelerated benefit distributions*
    - *No amendments increasing benefits*
    - *No unpredictable contingent event benefits (UCEBs)*
    - *No future accruals*
  - Restrictions on UCEBs and amendments increasing benefits generally apply as of first day of plan year (PY)
  - Restrictions on accelerated benefit distributions and future accruals generally apply after valuation date for PY (generally April 1 for calendar-year plan)

AFTAP

- Application of restrictions based on current year AFTAP
- Presumptions and operating rules can trigger restrictions until current year AFTAP is certified
- Absent current year AFTAP certification, AFTAP is presumed to be:
  - January 1 – March 31: prior year AFTAP
  - April 1 – September 30: prior year AFTAP less 10 percentage points
  - October 1 – December 31: < 60% (post–October 1 AFTAP certification does not overcome presumption)

Accelerated Benefit Distributions

- Section 436(d) of the Code includes "Limitations on Accelerated Benefit Distributions."
- An accelerated benefit distribution is referred to as a prohibited payment.
- A prohibited payment is any payment in excess of the monthly amount paid under a single life annuity (plus any Social Security supplements described in the last sentence of section 411(a)(9) of the Code) to a participant or beneficiary whose annuity starting date occurs during any period in which the limitation is in effect, any payment for the purchase of an irrevocable commitment from an insurer to pay benefits, and any other payment specified by the secretary in the regulations.

Accelerated Benefit Distributions

- What is a payment that could potentially be in excess of the foregoing limit?
- Any lump-sum payment that exceeds $5,000. Cash-outs that do not exceed $5,000 are exempt from the restrictions.
- Any Social Security level income option.
- Refunds of employee contributions plus interest.

Accelerated Benefit Distributions

- Installment payments over a fixed period of years.
- Annuities that include lump-sum features, such as a cash refund annuity or a life annuity with a term certain where the remaining payments could be paid in a single lump sum.
- Retroactive annuity starting date payments that are made in a single lump sum with interest for the missed retroactive payments.

Accelerated Benefit Distributions

- Special lump-sum death benefits that are sometimes paid in addition to the regular qualified preretirement survivor annuity.
- Ancillary benefits.
- Purchase of an irrevocable commitment from an insurer to pay benefits. This occurs if the plan purchases an annuity contract on behalf of the participant.

Limitation Triggers

- The limitation on paying the accelerated payment only is triggered if the payment exceeds the monthly payment in the form of a single life annuity (plus applicable Social Security supplements).
- The restrictions on prohibited payments are applied on a participant-by-participant basis depending on what options are available to the participant, the amount of the payment, and the monthly single life annuity amount otherwise payable to the participant.

Limitation Triggers

- The prohibited payment restrictions are in addition to the old and current high-25 restrictions that limit the amount that can be payable to a participant who is one of the 25 most highly compensated employees of the employer in any form other than an annuity.

Limitation Triggers

- If the AFTAP is at least 60%, but less than 80%, the plan may not make a prohibited payment after the valuation date for the plan year if the payment exceeds the lesser of:
  - 50% of the amount of payment that could be made without regard to this section; or
  - the present value of the maximum guarantee with respect to the participant under section 4022 of ERISA (determined under PBGC guidance using the section 417(e) interest rate).

Special Rules

- If a plan's AFTAP falls between the 60% and 80% range and restricted prohibited payments are available under the plan, each participant may receive only one prohibited payment during any period of consecutive years during which the plan is in the 60% to 80% range.
- Participants, beneficiaries, and alternate payees are treated as one participant for purposes of the restrictions.
- The restrictions on accelerated payments do not apply to any plan that was frozen as of September 1, 2005.

Required Alternatives if Restrictions Are in Effect

- If restrictions are in effect, the plan cannot stop offering the restricted option, unless the AFTAP is less than 60%. If the AFTAP is at least 60%, but less than 80%, if a portion of the benefit can be paid in the restricted form, it must still be offered for that portion.
- The plan **must extend** the following choices to participants when restrictions are in effect:
  - Bifurcate the benefit into the unrestricted and restricted portions; or
  - Commence payment of the entire benefit in an unrestricted form; or
  - Defer payment to a later date.

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Permissible Alternatives if Restrictions Are in Effect

- The plan **may permit** the following choices for participants when restrictions are in effect:
  - Take a partial distribution of the portion of the benefit that is unrestricted in the amount that is available for payment, and defer the restricted portion until a later date.
  - Offer special optional form of payment that is not regularly available but only available during the period when restrictions are in effect.
- Whatever methods the plan sponsor elects to have in place when restrictions apply must be uniformly applied to affected participants.

Amendments Increasing Benefits

- N/A if increase is under formula not based on participant compensation (e.g., flat dollar multiplier) and rate of increase does not exceed rate of increase of average participant compensation
- Amendment is treated as effective (and restrictions therefore apply if date occurs during PY) on first day any individual who is or could be a participant or beneficiary would be entitled to increase if individual satisfied any applicable conditions for increase
- Restrictions apply if AFTAP $\geq$ 80%, but increased benefits attributable to amendment would reduce AFTAP to < 80%
- If presumed AFTAP < 80%, but later certified AFTAP for PY $\geq$ 80%, amendment is effective retroactively and benefit increases apply
- Restrictions do not apply to benefit increases attributable to statutorily required accelerated vesting (e.g., top heavy)
- If benefits are increased in operation, and plan is later amended retroactively, AFTAP at operational increase controls

Unpredictable Contingent Event Benefits (UCEBs)

- UCEBs: shutdown or any event other than attainment of certain age, performance of service, receipt of compensation, or occurrence of death or disability
- Restrictions apply if AFTAP ≥ 60%, but UCEBs would reduce AFTAP to < 60%
- If presumed AFTAP < 60%, but later certified AFTAP for PY ≥ 60%, UCEBs must be paid retroactively
- Participants who experience UCEBs at different times may be treated differently if AFTAP changed during interim
- If multiple events trigger UCEBs, AFTAP at occurrence of last triggering event controls

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Notices

- Under ERISA section 101(f), in general a funding notice must be provided no later than 120 days after the end of the plan year to which it relates, e.g., by April 30 for a calendar-year plan, to all participants and beneficiaries under the plan regarding the funded status of the plan. As part of the notice, AFTAP is disclosed. Note that there is no requirement in the funding notice to refer to benefit restrictions. The funding notice is merely the public announcement of the funding status from which benefit restrictions will derive.

Notices

- A benefit restriction notice required under ERISA section 101(j) must be issued to participants and beneficiaries within 30 days of the plan's becoming subject to a benefit restriction. For a calendar-year plan, this means April 30.
- If the notice is issued because benefit payments in certain payment forms are restricted, the notice needs to be provided within 30 days of the restriction that is triggered as of a specific valuation date for the plan.
- If the notice is issued because the plan's AFTAP has fallen to less than 60% and benefit accruals must cease, the notice must be given within 30 days of the valuation date for which the 60% AFTAP applies.

Notices

- Failure to provide notice could trigger penalty of up to $1,000 per day per failure.
- There is no requirement to provide notice to participants already in pay status.
- There is no model notice that has been issued by the DOL.

204(h) Notice Issues

- ERISA section 204(h) requires generally that participants be notified 45 days in advance of any amendment to the plan that decreases the rate of future benefit accrual. As previously noted, if a plan's AFTAP drops below 60%, benefit accrual must cease. This would generally require a 204(h) notice. In this situation advance notice would not be available as the accrual would cease as of the applicable valuation date. The regulations were revised in 2009 to provide that the ERISA 101(j) notice meets the requirements of section 204(h) despite the fact that the 101(j) notice is provided after the restrictions are triggered.

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Lifting Restrictions

- Presumed election to reduce funding standard carryover balance (FSCB) and prefunding balance (PFB) to
  - Remove any restriction applicable to collectively bargained plan
  - Remove restriction on accelerated benefit distributions applicable to noncollectively bargained plan
- Dedicated contributions
  - Restrictions on amendments increasing benefits and UCEBs
    - *If AFTAP < applicable threshold, dedicated amount is cost of benefits/increases (including "at-risk" liability)*
    - *If AFTAP < applicable threshold only by taking into account cost of benefits/increases, dedicated amount is amount sufficient to reach applicable threshold (ignoring "at-risk" liability)*
  - Restrictions on future accruals: amount sufficient to increase AFTAP to 60%
- Provision of security in the form of (i) cash held in escrow by bank or insurance company or (ii) corporate surety bond

What Happens When and If Restrictions Are Lifted?

Four Mandatory Provisions

1. Once restrictions are lifted, any prohibited payments with annuity starting dates after the restrictions are lifted are subject to whatever restrictions, if any, apply to the plan. Thus, if a plan's AFTAP rises to 80%, unrestricted lump sums **must** again be available.

2. If benefit accrual had ceased based on an AFTAP less than 60%, if the restrictions are lifted, then accrual **must recommence** after the restriction ceases for benefits earned after the end of the restricted period unless the plan provides that accruals will not resume when the restrictions are lifted.

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What Happens When and If Restrictions Are Lifted?

3. If an amendment increasing benefits had been tabled due to AFTAP restrictions, the increase **must automatically go into effect** after the restrictions are lifted if the restrictions are lifted within the same plan year as of the first day of that plan year (or the effective date of the amendment if later). If the restriction is lifted in a later plan year, the plan is treated as if the amendment were never adopted.

4. A plan **must provide** that UCEBs that are not permitted to be paid during a particular year must automatically become payable, retroactive to the period those benefits would have been payable under the terms of the plan absent the restriction, if the restrictions are lifted later in that same plan year. If the restrictions are not lifted in the same plan year, then the plan is treated as if the contingent event benefit were never in the plan.

What Happens When and If Restrictions Are Lifted?

<u>Optional Choices</u>

- If benefit accrual had ceased based on an AFTAP less than 60%, if the restrictions are lifted, the plan **may provide** that benefit accrual is retroactively restored automatically for those periods in which the restrictions were in place.
- If an amendment increasing benefits had been tabled due to AFTAP restrictions, and the restriction is lifted in a year later than the year it was put into effect, the plan **may be amended** to provide for the benefits back to the original date.
- If a restriction is in effect when an unpredictable contingent event occurs and the restriction is lifted in a year later than the year the benefit would have been payable, the plan **may be amended** to provide for the benefit.
- A plan **may provide** that participants, whose annuity starting dates have already occurred during a restricted period, may make a new election for their benefits and any new election would be subject to applicable spousal consent.

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Plan Provisions – What to Include

- The IRS issued model amendments for the section 436 regulations last fall, well after most plans had adopted amendments to comply with the regulations.
- For those provisions that are mandatory, the plan should include the appropriate description and reference.
- For those provisions that are optional, the plan should not include the provision unless and until the restriction applies and a decision is made regarding the option.

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Plan Provisions – What to Include

- Options that should not be included:
  - Options That Arise When Restrictions Are First Triggered
    - *Option to permit the participant to take a partial distribution of the portion of the benefit that is unrestricted in the amount that is available for payment, and defer the restricted portion until a later date.*
    - *Option to offer special optional forms of payment that are not regularly available but only available during the period when restrictions are in effect.*

Plan Provisions – What to Include

– Options That Arise After Restrictions Are Lifted:

- *Option to make benefit accrual retroactive to the start of the restricted period if benefit accrual is frozen due to AFTAP's being less than 60%.*
- *Option to allow participants in pay status whose annuity starting dates occurred during the restricted period to make new benefit elections.*
- *Option to permit an amendment increasing benefits to take effect in a plan year subsequent to the plan year in which the restriction was both imposed and lifted.*
- *Option to permit UCEBs to be paid subsequent to the plan year in which the restriction was both imposed and lifted.*

Pension Relief Act of 2010 (PRA)

- Economic downturn in 2008 and 2009 and continued market volatility took toll on plan funding levels.
- Plan sponsor struggled to meet more stringent funding requirements that the Pension Protection Act implemented.
- PRA permits plan sponsors to elect funding relief for no more than two plan years from 2008 to 2011.

PRA

- Permits plan sponsors to amortize losses over longer periods.
- Two available elections
  - 2 plus 7-year amortization schedule
  - 15-year amortization schedule
- Election to use an alternative amortization schedule may affect ability to obtain a funding waiver.

Cash Flow Rule

- Additional contributions required if the plan sponsor or any entity in its controlled group pays excess compensation or makes excess shareholder payments.
- Dollar-for-dollar acceleration, but not to exceed:
  - Total shortfall base or
  - Amount that would have been required if the alternative amortization schedule had not been elected.
- Applies during restriction period.
  - 2 plus 7-year amortization schedule – 3 plan years
  - 15-year amortization schedule – 5 plan years

Excess Compensation

- Compensation paid during a calendar year to any employee in excess of $1 million, indexed for years after 2010.
- Employee includes:
  - former employee
  - self-employed individuals
- Compensation includes:
  - taxable compensation
  - amounts set aside to fund deferred compensation

Excess Compensation Exceptions

- Compensation for services rendered before March 1, 2010
- Nonqualified deferred compensation, restricted stock, stock options or stock appreciation rights that are paid or granted under a binding written contract that was in effect on March 1, 2010
- Restricted stock granted after February 28, 2010 that is subject to a substantial risk of forfeiture for at least five years from the date of grant
- Commissions

Excess Shareholder Payments

- Equals dividends declared during plan year + total amount of redemptions - (greater of plan sponsor's adjusted earned income for preceding plan year or historical dividend amount).
- Adjusted earned income – disregard EBITDA
- Historical dividends – dividends declared in same manner for at least five consecutive years

Excess Shareholder Payments
Exceptions

- Dividends declared and redemptions occurring before March 1, 2010
- Dividends paid within a controlled group
- Redemptions made pursuant to a benefit plan or made on account of death, disability, or termination of employment
- Certain dividends and redemptions with respect to preferred stock

Mergers and Acquisitions

- If both entities in merger or acquisition elected alternative amortization schedule, compensation amounts and shareholder payments for both companies involved in the transaction are combined as if they had been in the same controlled group before and after the transaction.
- If only one entity in merger or acquisition elected alternative amortization schedule, disregard aggregate compensation of employees of other entity and disregard any shareholder payments made prior to transaction.

Questions?

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