

Morgan Lewis

Introduction to  
Defined Benefit Plans

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# Defined Benefit Plan Basic Requirements

- Must be in writing
- Must create, organize and maintain trust in U.S.
- Must be properly established and communicated
- Must be “permanent”
- Must be for exclusive benefit of employees and their beneficiaries

## Basic Requirements (continued)

- May not permit assignment or alienation of benefits (with exceptions, for example, for QDROs, federal tax levies, and certain voluntary and revocable assignments)
- Must satisfy minimum funding standard
- Must provide retirement benefits only (with certain exceptions, for example, for incidental death benefits)
- General ERISA rules may apply – e.g., bonding of fiduciaries (not applicable to church and governmental plans)
- Special rules for church, governmental and multiemployer plans

# Participation

- Who can participate?
  - Employees of participating employers
  - Participating employers include primary plan sponsor and other controlled group companies (generally, subsidiaries owned 80% or more by a common parent) who join the plan
    - If non-controlled group companies participate (e.g., joint venture), plan may become a multiple employer plan –creates certain compliance issues

# Participation (continued)

- All controlled-group companies need not participate and all employees of all controlled-group companies need not be covered (but picking and choosing may raise coverage and nondiscrimination testing issues)
- All controlled group companies that are participating employers in the plan should formally adopt the plan on behalf of their covered employees
  - Caution: Plans often say they include primary sponsor and "affiliates that elect to participate and that are approved for participation by the sponsor." Failure to carefully document who is in and who is not may lead to claims and litigation later.

# Participation (continued)

- Which employees are actually eligible to participate?
  - Generally up to plan sponsor, but:
    - Can't violate other employment discrimination laws ("participation limited to men")
    - Can exclude union employees if retirement benefits have been the subject of good faith bargaining and bargaining agreement does not provide for their inclusion
    - Typically exclude nonresident aliens with no U.S. source income

# Participation (continued)

- Can exclude employees who do not meet minimum age and service requirements
- Cannot exclude employees who have reached a maximum age
- Cannot exclude individuals by name if plan passes coverage using average benefits test for coverage
- Cannot exclude employees on the basis of part-time employment alone
  - *Caution:* IRS will scrutinize exclusions by category to see whether they are disguised effort to exclude part-timers; must flesh out definition in plan (e.g., "temporary," "casual," "project")

# Participation (continued)

- Can exclude individuals who are not working as common law employees of the employer, such as independent contractors
  - Caution: Exclusions for "consultants" or "contractors" who are treated as non-employees should provide that if later recharacterized by a court or the IRS as common law employees, such individuals will only participate in plan prospectively
- Typical to exclude leased employees, but leased employees may need to be counted in coverage test
  - Caution: Exclusions for "leased employees" should clearly cover the initial year of service

# Participation (continued)

- May want to include provision excluding acquired employees until plan is specifically amended to provide for participation
- Participation by non-traditional employees should be addressed (e.g., on-call, per diem, project, seasonal . . .)
- Eligible employees must start participating no later than six months after completing a "year of service" (1000 hours or elapsed time) and attaining age 21 (can require two years if 100% vested)

# Minimum Participation Requirement

Plan must satisfy minimum participation requirement:

- If accruals are ongoing, must benefit at least 50 employees or 40% of employees (and at least 2 employees) in the controlled group
- If plan is frozen and not underfunded, the number of current and former employees with meaningful accrued benefits must equal the lesser of 50 or 40% of all current and former employees ("prior benefit structure")
- If former employees are accruing, must separately test; meet test if at least 5 former employees benefit and at least 60% are former non-HCEs

# Minimum Coverage Requirements

- Plan must satisfy one of the following coverage tests:
  - Percentage Test. 70% of all non-highly compensated employees (non-HCEs) must benefit under the plan
  - Ratio Test. The percentage of all non-HCEs benefiting under the plan must be at least 70% of the percentage of all HCEs benefiting under the plan
  - Average Benefit Percentage Test. The plan must benefit a nondiscriminatory classification of employees and the average benefit percentage for non-HCEs must be at least 70% of the average benefit percentage for HCEs

# Minimum Coverage Requirements (continued)

- In performing the coverage tests all employees of the controlled group are counted except:
  - Non-resident aliens with no U.S. source income
  - Collectively bargained employees for whom retirement benefits were subject of good faith bargaining
  - Employees not meeting minimum age and service requirements (e.g., age 21 and one year of service)
  - Employees of a qualified separate line of business
  - Employees of acquired entity (through end of first plan year starting after date of acquisition) if certain conditions met

# Minimum Coverage Requirements (continued)

- Plans that automatically meet coverage tests:
  - Plans that don't benefit any HCEs
  - Plans maintained by an employer with no non-HCEs
  - A plan or portion of a plan which covers only collectively bargained employees

# Vesting

- Vesting = satisfaction of service or other requirement that allows benefit to be retained when employment ends
- Benefit must become “vested” when employee reaches normal retirement age (commonly age 65, may be as young as 55 but need to show reasonable for industry if less than 62)
- Benefit must become vested under service-based schedule; takes into account service at or after age 18 with all controlled group members
- Benefit must become vested upon complete or partial termination of the plan, to the extent funded

# Vesting Schedules

- Traditional plans must vest using 5-year cliff vesting (i.e., 100% vested after 5 years of service) or 3-to-7-year graded vesting (i.e., vesting increases 20% per year starting after three years of service)
- Hybrid plans must vest using 3-year cliff vesting
- Top-heavy plans must vest using 3-year cliff vesting or 2-to-6-year graded vesting
  - (A plan (or a group of plans required to be combined) is “top-heavy” if the present value of the cumulative accrued benefits and account balances for key employees exceeds 60% of the similar present value for all employees.)

# Vesting Schedules (continued)

- Vesting service is generally determined using hours counting or elapsed time methods
- Different schedules may be used as long as vesting occurs at the same time or sooner
- Benefits attributable to employee contributions are vested

# Permitted Forfeitures

- Forfeitures in defined benefit plan may only be used to reduce future employer contributions
- Benefit can be forfeited if participant leaves when 0% vested and does not return before five consecutive one-year breaks in service occur
  - Caution: Break in service rules are difficult to apply; rehired employees are hard to identify
- If an unmarried participant dies, plan may provide no death benefit
- Unvested portion can be forfeited if participant receives cash-out of vested benefit (or withdraws mandatory contributions) and does not return and repay distribution

# Permitted Forfeitures (continued)

- Benefits may be suspended during post-normal-retirement-age employment (before April 1 following age 70-1/2) without providing an actuarial increase, subject to certain minimum service and notice requirements
  - Caution: Suspension notices are often not provided timely and are a common audit item for the IRS.
- Benefits may also be suspended for retirees rehired before normal retirement age
- Funding rules permit certain forfeitures for substantial business hardship where funding waiver is not available
- Benefits for HCEs are permitted to be reduced to prevent discrimination

# Benefit Accruals

- Formula for calculating benefits must be specified in plan
- An employee's "period of participation" must be taken into account
- Both service and compensation can't be prorated
- Service is generally determined using hours counting or elapsed time method
  - *Caution*: Hours counting rules generally can't be applied using payroll data generated for salaried employees.
- Compensation can be defined at the plan sponsor's discretion, subject to limitations described later
  - *Caution*: Determining compensation precisely as described in the plan may be difficult. Payroll data passed to administrator should be audited periodically.

# Benefit Accruals (continued)

- The benefit formula cannot be back-loaded (i.e., can't provide for very small accrual in early years and large accrual in later years); one of three complex anti-backloading rules must be satisfied
- Accruals can't be suspended or reduced because of the attainment of any age
- Special rules apply for hybrid plans
- Issue pending for “greater-of” formulas

# Benefits Accruals (continued)

- Formulas integrated with Social Security are permitted
- Participant must accrue benefits for period of qualified military service if the participant returns to work during period reemployment rights are protected
- Some plans provide accruals while participant is receiving short or long-term disability benefits
- A top-heavy plan must provide minimum benefits for non-key employees

# Traditional Benefit Formulas

- Benefits must be definitely determinable

## Examples

Monthly benefit of \$ X per month per year of service

Annual benefit of y% of final average earnings times years of service

## Definition of Accrued Benefit Under ERISA and the Code . . .

“In the case of a defined benefit plan, the employee’s accrued benefit determined under the plan...expressed in the form of an annual benefit commencing at normal retirement age”

(Code § 411(a)(7)(A)(i) and ERISA § 2(23)(A))

# Widget Company Defined Benefit Plan

- Accrued Benefit = 1% of Final Average Pay times Years of Service payable at Normal Retirement
- Final Average Pay – averaged over final ten years of service.
- Normal Retirement – age 65
- Years of Service – elapsed time from date of hire to date of termination

# Example 1

Widget hires Joe, who is age 35 on January 1, 1981. His average earnings for the period of 1981 – 1990 are \$25,000. On January 1, 1991 Joe's accrued benefit is:

$$1\% \times \$25,000 \times 10 = \$2500$$

He is entitled to an annual benefit of \$2500, commencing at age 65.

# Joe's Benefits

<b>Year</b>	<b>Final Average Earnings</b>	<b>Accrued Benefit</b>
1991	\$25,000	\$2,500
2001	\$50,000	\$10,000
2011	\$100,000	\$30,000

**Total age 65 benefit =  
\$30,000 annually**

## Example 2

Widget hires Mary, also age 35, on same day as Joe, and at same salary but on January 1, 2001, Mary goes to work for Ajax, which coincidentally has the same plan as Widget, and pays her the same amount as Joe.

# Mary's Benefits

## Mary's Benefits from Widget

<b>Year</b>	<b>Final Average Earnings</b>	<b>Accrued Benefit</b>
<b>1991</b>	<b>\$25,000</b>	<b>\$2,500</b>
<b>2001</b>	<b>\$50,000</b>	<b>\$10,000</b>

## Mary's Benefits from Ajax

<b>Year</b>	<b>Final Average Earnings</b>	<b>Accrued Benefit</b>
<b>2011</b>	<b>\$100,000</b>	<b>\$10,000</b>

**Total age 65 benefit =  
\$20,000 annually**

# Hybrid Plan Formulas

Cash Balance Plan –

Hypothetical employee accounts like a defined contribution plan

## Example

Each participant has an account credited with 3% of earnings annually; amounts in account also credited with interest at specified rate linked to long-term interest rates

# Hybrid Plan Formulas (continued)

Pension Equity Plan – annual credits typically based on age, service or a combination. The plan determines benefits by providing a “Schedule of Percents” that accumulate, and which are applied to final earnings, as defined by the plan.

## Example

<u>Age</u>	<u>Percent of earnings per year</u>
40 and Under	3%
40-50	4%
51 – 65	5%

If employee had 25 years of service under plan at age 65, benefit account would be 115% [(4% x 10) + (5% x 15)] of final earnings.

# Limits on Accruals

- Annual benefit payable as a life annuity starting at age 62 may not exceed \$195,000 (in 2010) or 100% of the participant's high-three-year average compensation, if less
- Annual compensation taken into account may not exceed the statutory limit (\$245,000 for 2010)

# Limits on Accruals (continued)

- Benefits must be nondiscriminatory in amount
  - Nondiscrimination requirements also apply to the manner in which benefits vest, rules for determining vesting and accrual service, and the availability of benefits, rights, and features.
- Accruals must be suspended if the plan's adjusted funding target attainment percentage (AFTAP) is below 60%

# Accruals Are Protected

- Benefits that have been accrued cannot be “cut-back” by plan amendment. This protection covers the accrued benefit, early retirement benefits or subsidies, and optional payment forms
- Besides the obvious (i.e., can’t amend benefit formula to provide smaller benefits), also can’t, for example, change actuarial assumptions to provide smaller benefits or add or adversely change suspension of benefit rules
- Future benefits can be reduced or suspended by plan amendment, generally subject to 45 days advance notice

# Distributions

- Survivor Annuity Requirements
  - Married participant must receive benefit in the form of a "qualified joint and survivor annuity" (QJSA) and must provide benefits in the form of a "qualified preretirement survivor annuity" (QPSA) to surviving spouse of vested participant who dies before annuity starting date
  - Unmarried participant must receive benefit in the form of a single life annuity
  - QJSA must be at least as valuable as any other form
  - May provide that the survivor annuity rules will not apply unless the participant and spouse have been married throughout the one-year period ending on the earlier of the participant's annuity starting date or the date of the participant's death

# Distributions (continued)

- Employer may not have discretion over timing and form of payment; distribution rules must be specified in plan
- In-service distributions are prohibited before earlier of age 62 or normal retirement age
- Distributions may commence at any time following termination of employment and before normal retirement date as permitted by the plan, but benefits are generally reduced for payment before normal retirement date
  - Some plans provide unreduced ("subsidized") benefits after 30 years of service or after meeting other age and service requirements

## Distributions (continued)

- Unless the participant elects to defer (by failing to apply or otherwise), distribution must commence by 60th day after the latest of the close of the plan year in which occurs (i) the date on which the participant attains the earlier of age 65 or the normal retirement age specified under the plan; (ii) the 10th anniversary of the year in which the participant commenced participation in the plan; or (iii) the participant's termination of service with the employer

# Distributions (continued)

- If provided by the Plan, participant may defer distribution until the "required beginning date"
- "Required beginning date" means April 1 of the calendar year following the later of (i) the calendar year in which the employee attains age 70-1/2, or (ii) the calendar year in which the employee retires (except with respect to a 5% owner).
- Benefits that have not commenced to be paid by "required beginning date" are subject to 50% excise tax on minimum amount that should have been distributed

# Distributions (continued)

- The benefit payable in the normal form (e.g., single life annuity) is actuarially adjusted for payment in an optional form
- Actuarial factors for adjusting for optional forms must be specified in plan
- Required interest and mortality for lump sums and certain other forms

# Distributions (continued)

- Restrictions apply to joint and survivor annuities with non-spouse beneficiaries
- A plan may not distribute a participant's benefit before later of age 62 or normal retirement age without the participant's consent
- No consent is required if the participant's benefit is valued at \$5,000 or less, subject to special rules requiring the distribution to be rolled over to an IRA on the participant's behalf if participant fails to elect cash or rollover treatment for distribution over \$1,000
  - Caution: Restrictions on payment of lump sums, level income options and certain other payment forms apply if AFTAP is below 80% or if plan sponsor is in bankruptcy and actuary has not certified AFTAP of at least 100%

# Taxation of Distributions

- Annuities are subject to federal income tax when paid
- Recipient may elect out of federal tax withholding on annuities
- Withholding applied as if annuity payments are wages
- Presumptions on withholding if participant does not indicate preference
- Payments made in lump sum are generally eligible rollover distributions subject to federal income tax (and withholding at 20%) unless rolled over to an eligible retirement plan

# Taxation of Distributions (continued)

- Lump sums may be rolled over to traditional and Roth IRAs, other qualified plans, 403(b) plans and governmental 457(b) plans
- Lump sums paid before age 59 ½ may be subject to a 10% early distribution penalty tax
- Annuities are always exempt from the penalty tax regardless of age when paid
- Distributions reported on Form 1099-R

# Distribution Elections

Comprehensive notice and election rules apply to distributions:

- QJSA notice describes QJSA for married participants and single life annuity for unmarried participants and all other optional forms
- Generally, QJSA notice and election materials must be provided in advance of a participant's elected annuity starting date
- QJSA notice and election materials must include information regarding financial effect of benefit election (amount), relative values of optional forms, right to waive qualified joint and survivor annuity, spousal consent requirement, and right to defer payment and consequences of failure to defer

# Distribution Elections (continued)

- Spousal consent may be blanket consent or consent to a specific form of payment and/or beneficiary
- Spousal consent must be in writing and witnessed by either a notary public or plan representative
- Election period is 30 to 180 days prior to the annuity starting date
- The minimum 30 day period may be waived if plan provides for this, participant elects to waive and actual payment does not begin until 7 days following notice

## Distribution Elections (continued)

- Retroactive Annuity Starting Date (RASD) occurs if QJSA notice is provided on or after the annuity starting date
- Example: NRD in plan is first day of month following age 65. Participant attains age 65 on November 15, 2010. On November 30, 2010, participant requests to retire on December 1, 2010. Plan sponsor not able to provide QJSA notice and election materials until December 15, 2010. Plan may provide for December 1, 2010 annuity starting date only if plan has RASD provision.

# Distribution Elections (continued)

- RASD process requires participant to be offered choice between retroactive payments with interest or a prospectively commencing annuity on a future annuity starting date after the QJSA notice is provided. (If this occurs after NRD, actuarial increase in benefit payable at the future annuity starting date would be required)
- If RASD is elected, spousal consent is generally required for any form of payment, if lump sum paid must value at RASD and actual distribution date, and interest must be applied for payment delay

# Distribution Elections (continued)

- RASD situations typically occur when a terminated vested participant does not commence payment at NRD and plan includes a provision that requires payment to occur at NRD
- Ways to avoid RASD
  - require participants to give employer minimum advance notice (e.g., 30 days) prior to annuity starting date
  - provide only for an actuarial increase in benefits if benefits commence after a terminated participant's normal retirement date

# Distributions

## Common Administrative Issues

- Completing notice and election process timely
- Providing all required information in QJSA notice
- Permitting retroactive annuity starting dates
- Making distribution when participant fails to apply at 65 or required beginning date
- Overpaying/underpaying benefits (including continuing payments after death, failing to apply QDROs or prior distribution offsets, using wrong lump sum conversion factors)

# Distributions

## Common Administrative Issues (continued)

- Applying limits on survivor benefits for non-spouse beneficiaries
- Treating commencement of auxiliary disability benefits as the annuity starting date
- Completing Form 1099-R

# Death Benefits

- Plan must provide that surviving spouse of vested participant who dies before benefits commence will receive QPSA
- QPSA benefit must be at least 50% (or larger) survivor annuity under QJSA provided for by plan
- Spouse must be eligible to start QPSA on earliest date participant could have started payment
- Surviving spouse must be permitted to defer payment of QPSA at least to participant's normal retirement date and actuarial increase must be provided if spouse defers
- Latest payment date is the date participant would have reached age 70-½ (if plan provides)

# Death Benefits (continued)

- Plan may charge for QPSA coverage and participant may opt out of QPSA benefit with spousal consent
- Complicated notice and election procedures if QPSA benefit may be waived
- Plan may provide for alternate or additional death benefits to non-spouse beneficiaries if participant dies before benefits commence
- Most defined benefit plans do not provide for a pre-retirement death benefit for single participants (exception cash balance and other hybrid plans) and benefits of single participant would revert to plan

# Death Benefits (continued)

- Non-spouse beneficiaries must receive pre-retirement death benefit based on 401(a)(9) rules
  - Full payment not later than 12/31 of fifth calendar year following calendar year of participant's death or payment must commence over beneficiary's lifetime not later than 12/31 of first calendar year following calendar year of participant's date of death
- If participant dies after his benefits commence to be paid to him, the form of benefit payment elected will determine whether any death benefit will be paid

# Plan Amendments

- Must be in writing and adopted as provided by plan terms
- If discretionary, must be adopted by end of plan year or earlier
- Amendments significantly reducing future benefit accruals or retirement subsidies generally require notice 45 days in advance
- Interim amendments reflecting law changes generally must be adopted by later of (i) due date for employer's tax return for year in which amendment is effective, or (ii) end of plan year in which amendment is effective

# Plan Amendments (continued)

- Amendments increasing plan liabilities generally may not take effect if the plan's AFTAP is less than 80% or would be less than 80% with the amendment taken into account
- Special rules apply to amendments changing vesting schedules
- If interim amendment deadlines are missed (common problem), may correct through IRS Voluntary Compliance Program (VCP)

# Plan Termination

- If plan assets are sufficient, employer generally can terminate plan at its discretion (unless plan is collectively-bargained)
- Partial termination may occur if employer action causes employment termination for 20% of participants or if benefits are frozen
- Upon termination or partial termination, benefits of affected participants must be vested to the extent funded (exception applies to plan freeze if plan is underfunded)

# Plan Termination (continued)

- Complete termination may require employer action to terminate plan, amendments to comply with law changes, 204(h) notice, notice of intent to terminate, notice of plan benefits, notice of annuity information, notice of annuity contract, IRS determination letter and PBGC filings, and PBGC post-distribution certificate
- The plan must specify a method for the allocation of assets to satisfy liabilities, subject to the allocation requirements of ERISA § 4044 and nondiscrimination requirements
- Plan assets generally must be distributed within IRS/PBGC time frames and depends on termination type

# Plan Termination (continued)

- If plan is covered, PBGC guarantees payment of benefits up to certain limits if terminated plan has insufficient assets
- Any surplus assets not allocated to participants may revert to the employer if the plan document so provides
- The amount of the reversion is taxable to the employer and is subject to a 50% excise tax unless 25% of surplus is transferred to a replacement plan or 20% of surplus is applied to increase benefits for participants

# Reporting and Disclosure

- SPDs and SMMs
- Benefit statements (at least once ever 3 years, or annual notice regarding how to obtain)
- Annual funding notice
- Form 5500
  - Caution: Plans are required to report information regarding deferred vested benefits on Form 8955-SSA (previously Schedule SSA of Form 5500). Plans should update information when reported benefits are distributed to avoid requests for benefits previously paid.
- PBGC Filing
- Website display of Form 5500 information
- Notice if benefit restrictions apply

# Consequences of Non-Compliance with Qualification Requirements

- Deductions taken on employer's tax return disallowed
- Trust earnings become taxable
- Vested benefits become immediately taxable to participants (only HCEs if failure solely relates to coverage)
- Favorable tax benefits (like rollovers) are not available

# Qualified Domestic Relations Orders

- Creates or recognizes the right of a spouse, child, or other dependent of a participant to receive all or part of the participant's benefit
- Must be a domestic relations order that identifies the plan, participant, and alternate payee and specifies the amount of benefit assigned and the number and timing of payments
- Order may not result in increased actuarial cost to plan
- Order may not provide alternate payee with benefit not otherwise available under plan

# Qualified Domestic Relations Orders (continued)

- Plan administrator must determine if order is qualified within a reasonable period of time after receipt
- Plan administrator must separately account for affected amounts while determination is pending
- Plan must have written procedures for determining whether a domestic relations order is qualified
- Plan administrator must promptly notify participant and alternate payee of receipt of order, provide copy of procedures, and advise of plan administrator's determination (including reason for determination that order is not qualified)

# QDRO Distributions

- Two types of orders – shared interest and separate interest
- Shared Interest Order provides for a portion of each payment being made to the participant to be paid to the alternate payee
  - Payments cease when participant dies unless alternate payee has been designated as beneficiary for survivor annuity
  - Shared interest order is the only order that can apply if a participant is receiving payment

# QDRO Distributions (continued)

- Separate Interest Order splits the benefit before it is paid and assigns a portion to the alternate payee on an immediate or deferred basis
  - Alternate payee may choose form of payment for her portion and payments are made over her lifetime

# Questions?

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