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Uniting defined benefit plan documents and administration in perfect harmony

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Defined benefit (DB) plan administration must be conducted under a complex arrangement of rules and regulations. Certainly many rock solid restrictions and limitations are set in statutory or regulatory stone and, therefore, offer no wiggle room about how the plan document must be drafted. At the same time, many other provisions offer flexibility in terms of the manner in which the plan complies with applicable laws. While the availability of such flexibility can make DB plan administration much smoother, it does the plan sponsor no good if the plan document fails to incorporate the preferred operational procedures.

To remain safely within the bounds of compliance, tax-qualified plans must not only satisfy legal requirements but also remain true to the terms of the plan document itself. Accordingly, great care must be taken when initially composing the plan document so that the terms accurately reflect the manner in which it will be administered. Too often, what seems like a preferred provision on paper proves to be an impractical administrative headache once the plan goes live.

This article reviews a few common provisions found in DB plans that at the very least can produce frustration for administrators and, at the worst, create scenarios where the plan no longer operates in accordance with the document. Suggestions are offered as to how plan sponsors can keep their plan documents in tempo with their administration as well as the IRS rules.

Suspension of benefits without suspension of compliance

There are two circumstances when a suspension of benefits is permitted without compromising plan compliance.

1. **Participants working beyond normal retirement date (NRD):** There is frequently a mismatch in this area among the plan language, the IRS rules, and the actual administration. The IRS rules give plan sponsors a choice when a participant works beyond his or her normal retirement date (NRD) and require that the option selected be spelled out in the plan document in one of two ways:

   - Provide participants the greater of an actuarially increased benefit or additional accruals for each year they work past NRD; or
   - Provide only the additional accruals and timely notify participants that, because no actuarial increase is being given to reflect the deferral of their benefit, their decision to work past NRD (i.e., instead of retiring and commencing payment) in effect creates a "suspension of benefits."

From a pure cost standpoint, the second option is less expensive. However, from a compliance perspective, this choice requires a degree of administrative diligence that is too often lacking in actual practice. Based on IRS reports of frequently encountered errors and Milliman's experience reviewing plans' administrative procedures, many plan sponsors are either not aware or forget that when this second option is used, they must provide a suspension of benefits notice (SOBN) to the participant during the month the participant attains his or her NRD.

Unfortunately, the IRS has not officially specified a method for correcting the failure to timely provide the notice. In the absence of such guidance, a relatively common practice is to credit the participant with the actuarially increased benefit (if greater than the additional accruals) for the period during which no notice was given. Thus, the plan sponsor sends the SOBN to the participant as soon as possible after discovering the missed deadline and applies the actuarial increase for the period covering the participant's NRD through the date of sending the notice. Plan sponsors using this method and submitting it to the IRS for review under the agency's corrections program(s) have received approval. Nevertheless, because such approvals technically only apply to the sponsors for whom they were issued, they have no precedential value for future corrections. Accordingly, plan sponsors should seek the advice of ERISA counsel on applying this method as an appropriate course of action.

Importantly, the plan document should not present the two options as an "either-or" solution. Rather, it should clearly specify which one will be used. Corrections are intended to fix isolated incidents that occur through unintentional and unexpected mistakes—they should not be written into the plan as "business as usual."

Accordingly, all plan sponsors should be familiar with their plan documents' language covering participants who work beyond NRD.

If the plan sponsor feels that it will be unable consistently to deliver SOBNs as participants near their NRDs, it should consider amending the plan to provide an actuarial increase to all participants affected. Alternatively, if the plan sponsor does not want to assume the additional across-the-board expense that such an amendment would entail, it should consider enlisting a third-party administrator to create alerts that would provide sufficient advance notice as participants approach their NRDs; doing so would enable the required SOBNs to be prepared and delivered timely. Regardless of the option selected, the law requires an actuarial increase for the period the participant works beyond April 1 of the year following the year he or she turns age 70½.

2. **Returning to work after commencing benefits:** Another situation in which a plan's suspension of benefit provisions may be out of compliance is when a participant terminates employment under the plan, commences receiving retirement benefits under the terms of the plan, and then is reemployed by the plan sponsor. There are two main reasons why plan sponsors may decide to suspend benefits in such situations:

   - From a philosophical standpoint, participants allowed to draw a salary at the same time they are receiving a pension may be viewed as "double dipping."

   - From a preventive perspective, sponsors want to avoid employees leaving just to trigger a distribution, shortly after which they seek their old jobs back.

   If the plan sponsor intends to apply a suspension upon reemployment, the plan document must include applicable and appropriate language. The rules generally permit payments to be suspended for months during which the participant works a minimum number of hours: at least (1) 40 hours total or (2) one hour in each of eight or more days or separate work shifts. In addition, the plan document must specify the permissible measurement option used. Accordingly, plan sponsors should check if their documents contain a provision for suspension upon reemployment and, if so, if the documents state which measurement option is in effect.

   If no option is specified, adopting a clarifying amendment will assist the plan's administrators in making sure benefit payments are only suspended in the months during which the participant's hours worked meet the applicable minimum. This provision may require a higher degree of administrative vigilance to correctly identify those months of suspension and comply with the terms of the plan. Note that because such a suspension is not mandatory, a plan sponsor that finds managing such tracking to be difficult should amend the plan to remove the suspension provisions. Alternatively, as with the SOBN provision discussed earlier, the plan sponsor could engage a third-party provider to assist with the monitoring.

Timing is key

When establishing and administering the provisions governing benefit commencement dates (BCD), sponsors need to confirm that their plan documents' language and their operational procedures synchronize so as to ensure that benefits do not start too early or too late but rather just right – right on time, that is. The following sections describe proactive measures that can be taken in pursuit of this purpose.

Does the plan permit deferrals beyond NRD?

The plan should state when the benefit *may* start as well as when it *must* start. The rules governing BCDs allow plan sponsors some flexibility. For example, the rules governing deferred vested benefits (i.e., benefits for participants who terminate employment with a vested benefit but before NRD) stipulate that:

- the plan *may* provide for a mandatory deferral of commencement of the participants' benefits but such deferral *must* not defer commencement beyond NRD; and

- the plan *may* permit such participants to voluntarily defer such benefit until the April 1 following the calendar year in which they attain age 70½.

With respect to the first bullet, many plans contain an early retirement date (ERD) and thereby allow participants who meet those requirements to commence benefits at such date. In this case, vested participants who terminate with the required number of years of service but who have not attained the required age must be permitted to "age in" to early commencement once they have attained the specified age. With "de-risking" options (including, for example, eliminating future benefit obligations by cashing out benefits) now garnering interest, more plans contain or are being amended to include provisions permitting immediate payment regardless of a participant's age. Plan sponsors adding this provision should ensure that the amendment addresses the additional actuarial reduction that will be applied if the participant opts for immediate commencement of benefits.

As for the second bullet, some plans allow for such extended deferral while many others do not. This latter group in particular often has a discrepancy between the plan provisions and the administration. Because these plans do not allow deferrals up to age 70½, they are in effect mandating commencing at NRD and, accordingly, do not address what happens if the benefit is not paid at NRD. Unfortunately, many plans miss this payout date for a variety of reasons, including: unawareness of the plan provision; no system to provide timely alerts about the upcoming payment date; or a failure to keep track of the whereabouts of the former employee. If the plan sponsor intends to force a distribution at NRD, it must do whatever is necessary–including obtaining the assistance of a third-party administrator–to get its administrative systems in order to ensure that the distribution occurs on a timely basis. A few scattered delays may be viewed as self-correction program candidates, provided they are operational exceptions and not the de facto rule. However, because the IRS expects plan sponsors to take appropriate action to prevent recurrences of the same error, their plans' qualification could be at risk if sponsors fail to adopt the necessary measures to enforce commencements at NRD and instead permit participants to passively defer payments beyond NRD by not filing the required paperwork.

Alternatively, plan sponsors may wish to amend such plans by replacing the requirement that benefits begin at NRD with language allowing participants to elect commencement of benefits at any age on or after NRD but by the statutorily required beginning date (i.e., the April 1 following the participant's attainment of age 70½). Because a benefit that is deferred beyond NRD must be the actuarial equivalent of the normal retirement benefit, the plan document must also be revised to clearly state the manner in which such a delayed benefit will be calculated.

Is the cash-out window open?

At first glance, tossing participants' benefits to them through the mandatory small-benefits cash-out window may seem like a "win-win," an easy out for a plan sponsor, as doing so allows it to distribute small benefit amounts while reducing administrative costs and Pension Benefit Guaranty Corporation (PBGC) premiums. However, sponsors must be mindful of how the plan document addresses this and determine if they have the administrative provisions in place to comply with the IRS rules. For example, if an employer is not regularly sweeping out amounts subject to the cash-out rules, the IRS may claim that the employer is not following the terms of the plan document, resulting in a plan qualification defect. The mandatory cash-out threshold is usually $5,000 or less, but sponsors can choose any amount less than $5,000. Participants may elect to take this distribution in cash or roll it over to another qualified plan or an individual retirement account or annuity (IRA). If participants fail to make an election, plans must provide default provisions of either automatic rollovers or retention of the amounts in the plan. A plan may also provide that if the distribution is $1,000 or less, a distribution in cash may be sent to the participant absent a participant's election to the contrary. However, not all sponsors seek to take advantage of the automatic-rollover feature, possibly because to do so requires that they negotiate contracts, which contain specific legal requirements, with auto-IRA vendors.

Consequently, the best practice for keeping the plan's window "clean" is for plan sponsors to:

- periodically review their distribution paperwork and compare it to the plan document rules;
- review their auto-rollover IRA vendor contracts for legally mandated requirements; and
- make sure they have established a regular (e.g., annual) cash-out sweep procedure if the plan document provides for that.

Plan's benefit request provisions

Another significant area of noncompliance relates to the paperwork that the plan administrator gives to employees when employees request distributions after termination of employment. This paperwork includes election and rollover forms that the employee must complete, as well as descriptions of optional forms of benefit and other required disclosures.

A plan sponsor typically wants to give the participants maximum flexibility for the timing of a request for the paperwork and their selection of a benefit commencement date (BCD). For example, a sponsor might wish to permit a participant retiring on June 1 to be able to alert the administrator during the last week of May and still be able to maintain June 1 as the BCD. Such flexibility may be desirable for the participants but puts the plan administrator in a difficult position, given the statutory requirements about the notice and the typical administrative process. This entails a turnaround time for:

- preparing the distribution package, which includes calculations of benefit estimates and relative values under the various optional forms offered under the plan;
- delivering the package to the participant; and
- having the participant return it to the administrator with all forms correctly completed and executed.

Plan sponsors also must take care not to violate the IRS notification rules for qualified joint-and-survivor annuities and options that may be rolled over. In both cases, the required notices may not be distributed more than 180 days or fewer than 30 days prior to the BCD. However, the plan may permit a participant to waive the 30-day requirement as long as the distribution is made more than seven days after the notice is provided.

Dealing with delays: To retro or not to retro?

Despite establishing appropriate administrative procedures to meet BCDs, unexpected delays still can occur. So how should the plan sponsor respond to such delays? Providing the participant a retroactive annuity starting date (RASD) is one solution, but is only available if the plan document includes the RASD rules. If such rules are not specified, RASD is not an option. Instead, the only means of addressing late payments is to pay interest on the benefit amounts to reflect the delay. Except for certain administrative delays that are due to issues concerning the calculation of the benefit, there can be no make-up payments going back to the "missed BCD."

If a participant who could have commenced distributions at his or her NRD experiences a delay in the starting date, there are two possible outcomes:

(1) The plan may specifically provide for a RASD. This allows the participant to elect to commence benefits at a delayed commencement date and to receive a single payment that is equal to all the "missed" payments retroactive to the NRD.

(2) If the plan is silent on what happens if the participant makes a benefit election after normal retirement age or specifies that an actuarial increase is necessary, the plan must actuarially increase the benefits from the NRD to the commencement date.

If the plan does provide for RASD, then it must offer the participant the choice between options (1) and (2) above.

In any event, plan sponsors should carefully review each scenario, as different termination dates and different dates for electing the commencement of benefits in relation to the NRD can result in the application of different plan provisions or regulations.

Harmonize or agonize

Each year the IRS and the Department of Labor (DOL) conduct thousands of audits of employee benefit retirement plans. The DOL in January 2016 reportedly announced that it is investigating large DB plan sponsors, including Fortune 500 companies, for their repeated failures to locate and pay terminated vested participants who are due distributions. While some plans had high-quality written procedures, sponsors or administrators apparently did not follow the procedures and, thus, were not locating the former employees. There were even cases where the recordkeeping had lapsed to such an extent that the plans' records did not have the participants' ages on file. The DOL's announcement came with a warning to plan fiduciaries: having procedures but failing to follow them could result in a fiduciary breach, thereby subjecting such fiduciaries to personal liability for any resulting adverse tax consequences incurred by the plan's participants.

While DOL audits focus on ERISA violations, the IRS audits concentrate on compliance with the Internal Revenue Code. Consequently, plan sponsors must constantly stay in tune with legal and regulatory updates that may require changes to the plan document language and/or plan administration. They need to be careful to always keep the document language in harmony with the employer's intent, the plan's actual administrative procedures and operation, and the IRS and DOL rules. Both agencies have a consistent pattern of issues they look for when they audit a plan. Because the IRS is eliminating the determination letter program for individually designed plans (see IRS Notice 2016-3), sponsors of such plans must be even more vigilant as they will lose the ability to submit their plans for the "compliance sound check" this program afforded.

This article examined some of the most common provisions that can cause plan sponsors to go "off key" and thus strike a discordant note that could result in an unfavorable IRS and/or DOL review. While plan perfect pitch (i.e., no administrative errors) may be difficult to reach, plan sponsors are urged to keep in harmony with their actuarial consultants and legal counsel to better focus on their internal controls. Doing so will keep their plans in compliance tune and prevent costly fines and fees in the event of an IRS and/or DOL audit.

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