Distributions from Defined Benefit Pension Plans

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I. BACKGROUND

The following is a general discussion of some of the issues and concerns which may arise under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code of 1986 (the "Code") with respect to a defined benefit plan's providing for in-service distributions. Specifically, this memo addresses the legal provisions which govern when a defined benefit plan can begin to distribute benefits (commence benefits), and assuming such benefits have validly commenced, when such benefits can be withheld (suspended).

The following is only a brief overview of some of the legal issues raised under ERISA and the Code with respect to the rules surrounding commencement and suspension of benefits. The topics covered herein are inherently factual in nature, as the applicable legal provisions afford plan sponsors significant flexibility in drafting plan provisions governing when benefits may commence and, if applicable, when such benefits may be suspended. As such, the applicability of the legal provisions discussed herein are, to a large extent, dependent upon the terms of the applicable plan document. Because these issues are complex, highly technical and factual in nature, questions arising in connection with a commencement or suspension of benefits issue should be referred to qualified ERISA counsel and be dealt with on a case by case basis.

We further note that due to the Coronavirus Pandemic, the natural arc of employment for employees in virtually every industry will be impacted in many (perhaps unforeseen) ways. There may be employees looking to "retire early" due to health reasons and others leaving retirement to rejoin the workforce due to financial stress. As a result, the issues of benefit commencement and suspension as they relate to ERISA-governed defined benefits plans have become even more prevalent.

II. COMMENCEMENT OF BENEFITS

A retirement plan may allow for the distribution of benefits only where it is not contrary to the distribution restrictions provided by law applicable to that type of retirement plan. The distribution restrictions vary based on the type of retirement plan. For example defined benefit pension plans (as well as money purchase plans) are subject to different rules than those applicable to profit sharing plans, and additional rules apply to 401(k) plans. Plans are allowed, and often do, contain additional restrictions on benefit distributions than those provided by law. As such, the applicable plan document will control in determining when distributions are available, so long as the document does not allow for distribution for a reason or at a time that is not permitted by law. This memo primarily will discuss the rules applicable to defined benefit plans.

The tax qualification rules of Code section 401(a) require that a defined benefit plan be established and maintained primarily to provide systematically for the payment of definitely determinable benefits after (1) retirement or (2) the attainment of normal retirement age. Treas. Reg. sec. 1.401(a)-1(b)(1)(i). The Pension Protection Act of 2006 provided plan sponsors with additional flexibility, by permitting defined benefit pension plans to allow for in-service distributions to a participant who has reached age 62, even if the plan's normal retirement age is later than age 62. Code sec. 401(a)(36). The Setting Every Community Up for Retirement Enhancement Act of 2019 (the "SECURE Act") reduced the minimum age for in-service distributions from age 62 to age 59½ (again, irrespective of the plan's normal retirement age).

While the Code and underlying regulations provide that benefits may commence upon attainment of the plan's normal retirement age or age 59½, many plans are drafted to require that the participant retire—have terminated employment—in order to become eligible for benefits. Additionally, the reference in the regulations to benefits being payable "after retirement" allows for benefits from a defined benefit plan to become payable after a termination of employment, even if such termination occurs well before the participant's attainment of the plan's stated normal retirement age. However, a plan is not required to permit a terminated participant from electing distribution before the attainment of normal retirement age. Code section 401(a)(14). Hence, while a defined benefit plan could allow for a vested participant who terminates employment to elect to immediately commence receiving a benefit, many plans will require that the participant wait until he or she has reached the plan's normal retirement age, or an applicable early retirement age.

Unless the plan document allows for in-service distributions to participants who have reached their normal retirement age or age 59½, a participant must retire to become eligible to commence receiving his or her pension benefit. ERISA and the Code provide limited guidance as to the definition of "retirement." Generally, however, a participant will only be considered as having retired if he or she is no longer employed by the employer. A defined benefit plan may not treat a participant as having retired merely because of a reduction in the number of hours worked. See Treas. Reg. §1.401(a)-1(b)(3).[1]

The IRS, in IRS Private Letter Ruling 201221033, has cautioned that a participant must legitimately retire in order to commence receiving a benefit. In this ruling, participants in a defined benefit plan who satisfied the age requirement for an early retirement benefit "retired" such that their benefits could commence, with an understanding with their employer that they could return to work the next day or within the week. The IRS concluded that, in general, the retirements were not *bona fide*. Consistent with this ruling, the Treasury Department also warned in the preamble to its proposed regulations on phased retirement (see footnote 1), that the regulations "specifically do not endorse a prearranged termination and rehire as constituting a full retirement."

III. SUSPENSION OF BENEFITS

The suspension of benefit rules are essentially an exception to the vesting rules that require a participant's right to his or her normal retirement benefits to be nonforfeitable at normal retirement age. A plan is not required to contain suspension of benefits provisions, although it is common for a defined benefit plan to contain such provisions. However, because the rules are not mandatory, the plan document will govern whether the rules apply and, to the extent allowed by law, how the rules apply.

If a plan does not contain provisions providing for the suspension of benefits, qualified ERISA counsel should be consulted prior to adding any such provisions, because the anti-cutback rules of ERISA and the Code prohibit the Plan from applying any newly added provision to benefit payments that result from benefits accrued prior to the adoption of the new provisions.

A. What is a suspension?

Suspension refers to the permanent withholding of a participant's benefit payment for each month in which the participant is in disqualifying employment after reaching their normal retirement age. In general, a defined benefit pension plan may provide that in certain circumstances, if a retiree receiving benefits under the plan becomes reemployed, his or her benefits will be suspended for the duration of his reemployment. These rules can also apply to participants who remain actively employed, continuing to work after reaching their normal retirement age.

When a participant's benefit is appropriately suspended, no adjustment to a participant's accrued benefit is required. Specifically, the plan will not have to actuarially increase a participant's benefit to reflect the period of suspension. Thus, if a participant accrues additional benefits as a result of employment past normal retirement age and the plan suspends payment of benefits in accordance with ERISA section 203(a)(3)(B), the plan does not have to provide *both* the accrued benefit determined with the additional accrued benefit earned after normal retirement age and the actuarial equivalent of the accrued benefit at normal retirement age. Treas. Reg. sec. 1.411(b)-2(b)(4)(iii)(B).

Note if a participant remains in employment past age 70½, his or her benefit cannot be suspended. As a result, the accrued benefit of a participant working past age 70½ must be actuarially increased to take into account the period of service after age 70½ in which the participant does not receive any benefits under the plan. Code sec. 401(a)(9)(C)(iii).

B. When can benefits be suspended?

Code section 411(a) requires that a participant's right to his normal retirement benefit be nonforfeitable upon the attainment of normal retirement age. However, Code section 411(a)(3)(B) provides a limited exception to this requirement. It provides that the failure to pay nonforfeitable benefits, i.e., the suspension of benefits, to a participant after the normal retirement age will be a permissible forfeiture under section 411(a) if the participant is "employed," as that term is defined in DOL Reg. section 2530.203-3.

Not all employment will meet this definition of "employed" such that a retiree's benefit can be suspended (referred to as "disqualifying employment"). Because these rules are fairly complex and fact specific, DOL Reg. section 2530.203-3(b)(6) requires that plans adopt procedures to help employees understand what counts as disqualifying employment.

First, in order for employment to be considered disqualifying employment, in the case of a single employer plan, the participant must be employed by the employer maintaining the plan under which the benefits are being paid. With respect to a multiemployer plan, for employment to be considered disqualifying employment, it must meet three criteria:

1. If the Treasury later finalizes regulations on phased retirement (see Prop. Treas. Reg. §§1.401(a)-3), plan provisions might be adopted that would allow in-service distributions from defined benefit plans before normal retirement age due to a reduction in hours. However, plans may not rely on these proposed regulations pending the issuance of final regulations.

- **Industry.** The service must be in an industry in which covered employees were employed and accrued benefits at the time that payments of the retiree's benefits commenced or should have commenced. An industry means the types of business activities engaged in by any employers maintaining the plan.

- **Trade or Craft.** The service must be in a trade or craft in which the employee himself was employed at any time under the plan. A "trade or craft" is generally a skill learned through significant training in an industry, or one involving selling, retailing, managerial, clerical, or professional occupations. It can also be a supervisory activity related to those skills.

- **Geographic Area.** The service must be in the geographic area covered by the plan at the time that payments of the retiree's benefits commenced or should have commenced. The "geographic area" covered by the plan includes any state or province of Canada in which contributions were made or required to be made to the plan, as well as any Standard Metropolitan Statistical Areas which fall in part within that state or province.

Second, a retiree will only be considered to be employed in disqualifying employment if the retiree completes 40 or more hours of service in a given month. If a plan does not determine or use the actual number of hours of service, this requirement can be fulfilled if the employee receives payment for any hours of service performed on each of eight or more days in a month.

The suspension of benefits rules only apply to benefits commencing on or after normal retirement age. In the case of benefits commencing prior to normal retirement age (i.e., early retirement benefits) a pension plan may suspend benefits for *any reemployment* by the retiree, whether "disqualifying" or not, to the extent that the suspension does not affect the retiree's entitlement to normal retirement benefits payable after attainment of normal retirement age, or the actuarial equivalent thereof.

C. Notice Requirements

The rules as to the procedures that must be followed to suspend a participant's benefit are promulgated by the DOL. To suspend such an individual's benefit, the plan must send a written suspension of benefits notice to the retiree during the first month in which payments are withheld. To comply with ERISA's nonforfeitability requirements, the plan must also send a suspension of benefits notice to participants who reach the normal retirement age and continue to work, unless these participants will be paid an actuarially increased benefit upon retirement. The notice must contain:

1. A description of the specific reasons why benefits are being suspended.
2. A general description of the plan provisions relating to the suspension of payments.
3. A copy of such provisions.
4. A statement to the effect that applicable Department of Labor regulations may be found in DOL Reg. section 2530.203-3.
5. The plan's procedure for reviewing the suspension of benefits.

If the plan requires the filing of a benefit resumption notice, the suspension notice must also describe the procedure for filing and forms for such notice.

If the plan suspends a participant's benefits but fails to provide this required notice, the plan must provide that the individual's subsequent retirement benefit will be actuarially increased to reflect the period of suspension. DOL Reg. section 2430.203-3(b)(4); *see also* Rev. Rul. 81-140, 1981-2 C.B. 180. If a plan fails to comply with DOL notice of suspension requirements and does not provide for an actuarial increase in benefits, any benefit suspension after normal retirement age could result in an impermissible forfeiture under Code section 411(a)(3)(B). Alternatively, the plan could be required to provide participants who did not receive notice with the greater of the actuarial increase or the accrued benefit taking into account post-normal retirement date service.

IV. CONCLUSION

Trustees and administrators of defined benefit pension plans should carefully review any rules and practices related to the commencement and suspension of retirement benefits in order to ensure that they are in compliance with the distribution rules under the Code and ERISA. Additionally, if claims for benefits are brought by participants, trustees and fiduciaries are well-advised to consult with ERISA qualified counsel and administratively adjudicate participants' claims according to the plan document and record the reasoning of their decisions, so that they may be afforded deference should a litigation arise.

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