PRUDENTIAL RETIREMENT

Pension ANALYST

IMPORTANT INFORMATION | **Distributions and Withdrawals** | **February 2004***

Restricted Benefits *Revisited*

WHO'S AFFECTED This guidance primarily affects sponsors of qualified defined benefit plans and participants in those plans who are among the employer's highest paid employees and receive single sum payments. They also apply to money purchase plans that have a funding deficiency or a funding waiver in effect. The rules do not apply to state and local governmental plans. Church plans that do not elect to be covered under ERISA (i.e. non-electing church plans) must make a good faith effort to comply with these rules.

BACKGROUND AND SUMMARY While the rules regarding restricted benefit payments have not changed in the past 11 years, the changing economic climate (i.e., low return on plan assets and increased pension liabilities) and the increased interest in adopting cash balance plans, have made the restrictions on single sum payments a more important consideration.

IRS rules require defined benefit plans (and certain money purchase plans) to restrict payments made to certain highly-paid employees. These rules were designed to prevent the highest-paid employees from draining plan assets and leaving insufficient funds to pay benefits to other participants.

This issue of Prudential's *Pension Analyst* revisits the rules on restricted benefits. It also reviews the types of security arrangements that can be made to permit plans to make total distributions to participants who are subject to benefit restrictions.

ACTION AND NEXT STEPS Sponsors of defined benefit plans that offer single sum payments as an option should take note that single sum payments may not be immediately distributable to restricted employees, if certain funding tests are not met. Payment alternatives may be available within the plan. In addition, a plan may allow an affected participant to provide security for payments that exceed the non-restricted amount.

Plan sponsors should review their administrative procedures for determining who is a restricted employee. In addition, employers may want to consider amending their plans to accommodate alternative arrangements, if those options are not currently available under the plan. If you need help identifying participants whose benefits are restricted, or determining restricted amounts, you should contact your plan's enrolled actuary or your Prudential Retirement representative.

*Republished December 2004 to reflect Prudential Financial's acquisition of CIGNA's retirement business.

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RELATED DOCUMENTS

Identifying Restricted Employees

The first step in identifying a plan's "restricted employees" is identifying the employer's HCEs (Highly Compensated Employees). To make the HCE determination all employers within the controlled group must be aggregated and treated as a single employer.

Any active or former highly compensated employee (HCE) may be subject to benefit restrictions if a single sum payment is selected. The regulations do allow the plan to limit the size of the highly paid group to 25 individuals, or a larger number chosen by the employer. If the plan imposes a limit, selection of the highest paid is based on compensation earned in the current or in any prior year.

Application of Benefit Restrictions

Special limits are placed on single sum payments made to restricted employees when:

- After the single sum payment is made, the value of the remaining plan assets is less than
- 110% of the value of its current liabilities; and
- The value of the participant's entire benefit is 1% or more of the plan's current liabilities
- before distribution of those benefits; and
- The value of the participant's entire benefit is more than $5,000.

IRS officials have informally stated that restrictions continue to apply to the beneficiary of a deceased restricted employee if the deceased employee was a restricted employee in the current or any prior plan year. In addition, some IRS officials have stated that an alternate payee entitled to a benefit under a Qualified Domestic Relations Order is subject to the same restrictions. In other words, the highly paid participant and alternate payee are treated as one employee for purposes of determining if there is a restriction on payments payable to either party.

If a participant's benefits are restricted, his annual payments are limited to the amount of his accrued benefit when paid as a straight life annuity, plus the amount payable under any social security supplement offered by the plan.

For example: A Defined Benefit Plan provides for a normal retirement benefit equal to 2% of final average compensation times years of service. This benefit is paid to unmarried participants in the form of a straight life annuity, while married participants receive the equivalent of this benefit paid on a 50% joint and survivor basis. Employees who retire before they are eligible to receive Social Security benefits may receive a supplemental benefit from the Plan until they become eligible for Social Security benefits.

John is a "restricted employee" in the Plan. He is 65 years old, married, and the annual amount of benefit payable to him as straight life annuity is $50,000. The Plan applies a joint and survivor adjustment factor of .95 to determine John's retirement benefit payable at age 65 under the Plan's form of annuity for married participants. In addition, the Plan provides a social security supplement of $2,000 per year until he reaches his social security retirement age (i.e., age 67).

Without the supplement, John's annual joint and survivor benefit is $47,500 ($50,000 x .95 J&S adjustment). However, his non-restricted benefit amount is $52,000, because the amount of benefit payable to him as straight life annuity is $50,000 and the value of the Social Security supplement is $2,000.

Payments from the Plan

A restricted employee is not necessarily limited in his choice of payment options. These restrictions only limit the dollar amount that can be immediately distributed from the plan. As a result, the plan may distribute the remaining balance of the single sum distribution, adjusted for interest, as soon as the restrictions no longer apply.

For example: John retires on January 1, 2004 and elects to take a single sum payment in the amount of $572,000. John is a restricted employee.

The restricted amount of this payment is $520,000 ($572,000 minus the $52,000 nonrestricted amount as noted above). John will receive $52,000 as an immediate payment. The Plan allows the remaining lump sum, adjusted for interest, to be paid to John when the restrictions no longer apply. On January 1, 2005, John is no longer included in the 25 highest paid group and therefore is no longer a restricted employee. As a result, the Plan may distribute the remaining $520,000 lump sum, adjusted for interest.

Acceptable Security Arrangements

A plan can allow a participant to take an immediate single sum payment of his benefits, even if that payment is subject to the restrictions noted above. However, the participant must make acceptable arrangements to repay any of the restricted amounts, if the plan should terminate without sufficient plan assets to pay benefits that are due all participants. Acceptable arrangements include:

- Establishing an escrow account;
- Posting a bond; or
- Obtaining a bank letter of credit.

If the participant uses an **escrow account arrangement**, he must escrow 125% of the restricted amount (the amount that he normally would not have received due to the benefit restriction rules).

For example: On January 1, 2004, John decides to take a single sum payment of $572,000 from the Plan. The restricted amount of this payment is $520,000 ($572,000 minus the $52,000 non-restricted amount). To receive the entire $572,000 payment, John must deposit $650,000 into an escrow account [125% x $ 520,000].

If the market value of the escrow account falls below 110% of the restricted amount, the participant must deposit additional funds to bring the account's value up to 125% of the restricted amount. However, if, at any time, the amount in escrow exceeds 125% of the restricted amount, the participant may withdraw the excess amount. In addition, as long as the value of the escrow account is at least 110% of the restricted amount, the participant may receive any income earned on the escrowed funds. The escrow agent cannot be the plan, the plan sponsor, or Prudential.

If a participant wants to **post a bond** to secure the restricted amounts, the amount of the bond must equal at least 100% of the restricted amount. The participant must obtain the bond from an insurance company (other than Prudential), bonding company, or other agency approved by the U.S. Treasury Department as an acceptable agency for securing federal bonds.

As a final alternative, a participant may obtain a **bank letter of credit** in an amount equal to at least 100 % of the restricted amount.

Changes in Security Amounts

After a restricted employee receives a single sum payment, his "restricted amount" will change each year. These changes will affect the amount that must be secured by an escrow account, bond or letter of credit.

The restricted amount is the difference between the accumulated amount of payments made to the employee and the accumulated amount of the employee's non-restricted benefit. To determine these accumulated amounts, the plan must use a reasonable interest rate.

For example: As of January 1, 2005, the Plan calculates John's 2005 restricted amount as follows, using an interest rate of 6%:

Accumulated Distributions: $572,000 x 1.06 = $606,320
Accumulated Non-restricted Benefit:
2004 Non-restricted Benefit of $52, 000 x 1.06
+ 2005 Non-restricted Benefit of $52,000
= $107,120

2005 Restricted Amount = $606,320 –107,120 = $499,200.

On January 1, 2005, John would have to have at least $624,000 ($499,200 x 1.25) in his escrow account.

The IRS has informally stated that the amount of bonding or the amount covered by the bank letter of credit could be reduced to 100% of the lower restricted amount (i.e., $499,200).

Releasing the Security

Any of these security arrangements must remain in force until the plan administrator certifies that the participant is no longer obligated to repay to the plan any part of the restricted amount. A plan administrator can make this certification at any time that:

- Plan assets equal or exceed 110% of current liabilities;
- The present value of the participant's future non-restricted limit is less than 1% of the plan's current liabilities;
- The present value of the participant's future non-restricted limit is $5,000 or less;
- The participant is no longer a restricted employee; or
- The plan has terminated and the benefit received by the participant is determined to be nondiscriminatory.

Repayment and Escrow Agreements

To help employers comply with the benefit restriction rules, we have created two sample agreements. The sample "Repayment Agreement" is an agreement between the plan administrator and the participant regarding the security arrangements made for the restricted portion of the benefit payment. The sample includes alternative provisions for payments made directly to the participant and payments that are directly rolled over to an Individual Retirement Account or Annuity (IRA) or other plan that accepts rollovers from a qualified pension plan. It also includes alternative provisions for each of the three types of security arrangements.

The sample "Escrow Agreement" is an agreement among the plan administrator, the participant, and a bank to hold the restricted portion of a payment in escrow. If a restricted benefit payment is rolled over to an IRA, the IRA trustee may agree to be the escrow agent.

You should consult your own legal advisor before adapting these sample documents for use with your plan.