Actuarial Principles for Pension Attorneys

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Actuarial equivalence

- The condition in which two or more payment streams have the same present value based on appropriate actuarial assumptions
- Actuarial equivalence principles used to convert benefits into different forms and/or payment periods so that the total value remains equal regardless of benefit form or commencement date
- Combines:
  - Time value of money (interest discounting), and
  - Life contingencies (the probability of receiving payment)
- Actuarial equivalence applies at the time of determination
  - Future events may cause one payment stream to be more/less valuable than another

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Actuarial equivalence

- Time value of money
  - If I owe you $1,000 in one year, I can invest $943.40 today and it will grow to $1,000 in one year at 6.0% interest
    - $943.40 x 1.06 = $1,000
    - $1,000 / 1.06 = $943.40
  - If I owe you $1,000 in one year, I can invest $909.09 today and it will grow to $1,000 in one year at 10.0% interest
  - Higher assumed interest rates create lower present values
- Life contingencies
  - If I owe you $1,000 in one year, but there is only a 90% chance you will collect it, I can invest $849.06 today and it will grow to $900 in one year

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Interest rates

- Two basic types
  - Single rate for all future years
  - Segment rates – introduced by Pension Protection Act
- Segment rates
  - Splits future into three time periods, or “segments”
    - Next five years (first segment rate)
    - The following 15 year period (second segment rate)
    - Everything after 20 years (third segment rate)
  - Reflects the concept that the longer you have until a payment is due, the greater the investment return you could earn during the deferral period

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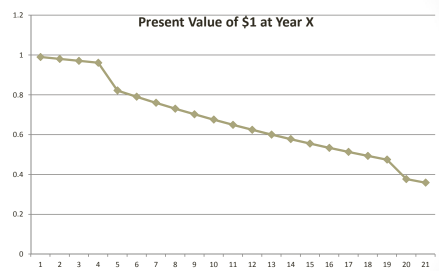
Segment Rate Example 1% / 4% / 5%



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Actuarial equivalence:
Plan provisions

- Plan document will specify interest rates and mortality table to be used for actuarial equivalence calculations
  - Converting between different annuity payment forms
  - Converting an annuity to a lump sum
  - Adjusting a benefit for deferral of commencement past normal retirement (actuarial increase)
  - Other purposes
- Some plans use simplified basis (fixed factors) in place of stated interest and mortality rates
  - Early / delayed retirement
  - Optional annuity payment forms

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Actuarial equivalence:
417(e) Rules

- Basis to use for converting annuity payment to any accelerated payment form (such as lump sum) IRC §417(e) & parallel provision of ERISA
- Applies to;
  - Lump Sum
  - Social Security Leveling Option
  - 10 Year Certain
  - Certain combination forms

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Actuarial equivalence:
417(e) Rules – Question from Attorney

- Client is unmarried, she retired at age 56, and in looking at her election form, had she taken the single life annuity of $155.65 vs. the leveling option of $296.60 until age 62 (and then $0), she would've have been much better off. If life expectancy at age 56 would be 28 years, that would be age 84 = 28 years of payments. 28 years of $155.65 = $52,298.40 vs. 72 payments to age 62 she received of $296.60 = $21,355.20.

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Overpayment and recoupment requests

- Employers often demand or request, but may not follow through.
- Rev. Proc. 2015-27
- "Plaintiffs are correct that an ERISA fiduciary may be held liable not only for disseminating materially misleading information, but also for failing to affirmatively provide material benefits information, whether on its own accord or when prompted by a participant's inquiry, in the event of a nonfiduciary's misrepresentation." *Veturis v. Boeing* (WD Washington 2015)
- Interest rate issue:
  - Does Plan specify an interest rate? (Rarely.)
  - What interest rate is appropriate? Plan actuarial equivalence may be based on rates from 1980's – 7% or 8% – not necessarily appropriate today.
  - Why should participant be charged interest? This would not occur in any other context.

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Faulty prior estimates

- Participant receives benefit statements for years showing benefit of $5,365 per month at age 65.
- Age 65 comes – benefit is $2,303 per month. Oops.
- Law on this point is bad for plaintiffs (*Pearson v. Voith Paper Rolls, 656 F. 3d 504 (7th Cir. 2011)*), but employers generally want to give the money to employees.
- **Practice tip**: give the employer an *excuse* to pay the participant. See *Veturis*, for example.
- **Also**: don't let participant talk to plan administrator.

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Benefit accrual rules aka "Backloading"

- Purpose of benefit accrual rules is to prevent "backloading" of benefit accruals
  - Cannot use plan's benefit formula as an "end run" around the minimum vesting standards
  - Big issue for cash balance plans
- The benefit formula must satisfy one of three rules
  - 3% rule
  - 133-1/3% rule
  - Fractional rule
- Complicated analysis when a plan has multiple concurrent or grandfathered benefit formulas
- Rules are poorly designed and in particular, do not work well with multiple formulas or complex plans, and therefore many plans fail. IRS relief may not prevent participant plaintiffs from winning.
- Some "creative" ways of solving backloading problems are "too cute."

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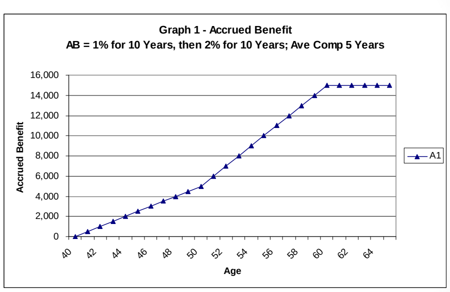
Backloading – 3% Rule



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Backloading – 3% Rule

- Projected benefits is "as if" employee entered at earliest possible age.
- Accrued benefit calculated using actual current average comp. However, projected benefit based on future average comp assuming each year's future comp is equal to a current average using no more than 10 years. The IRS assumes that future average comp = current average comp.

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Backloading – Fractional Rule

411(b)(1)(C) - A defined benefits plan satisfies the requirements of this paragraph if the accrued benefit to which any participant is entitled upon his separation from the service is not less than a fraction of the annual benefit commencing at normal retirement age to which he would be entitled under the plan as in effect on the date of his separation if he continued to earn annually until normal retirement age the **same rate of compensation** upon which his normal retirement benefit would be computed under the plan, determined as if he had attained normal retirement age on the date on which any such determination is made (but taking into account **no more than the 10 years of service** immediately preceding his separation from service). Such fraction shall be a fraction, not exceeding 1, the numerator of which is the total number of his years of participation in the plan (as of the date of his separation from the service) and the denominator of which is the total number of years he would have participated in the plan if he separated from the service at the normal retirement age. For purposes of this subparagraph, **social security benefits and all other relevant factors used to compute benefits shall be treated as remaining constant as of the current year for all years after such current year**.

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Backloading -133-1/3% Rule

411(b)(1)(B) - A defined benefit plan satisfies the requirements of this paragraph for a particular plan year if under the plan the **accrued benefit payable at the normal retirement age** is equal to the normal retirement benefit and the annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age under the plan for any later plan year is **not more than 133-1/3 percent of the annual rate at which he can accrue benefits for any plan year beginning on or after such particular plan year** and before such later plan year. For purposes of this subparagraph-

(i) **any amendment to the plan which is in effect for the current year shall be treated as in effect for all other plan years**;
(ii) any change in an accrual rate which does not apply to any individual who is or could be a participant in the current year shall be disregarded;
(iii) the fact that benefits under the plan may be payable to certain employees before normal retirement age shall be disregarded; and
(iv) **social security benefits and all other relevant factors used to compute benefits shall be treated as remaining constant as of the current year for all years after the current year**.

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Backloading – 133% Example

Acc Ben = Max (A,B)

A = 1% x FAP x YOS

FAP = 15 year average

B = 2% x FAC x YOS (up to 10)

FAC = 5 year average

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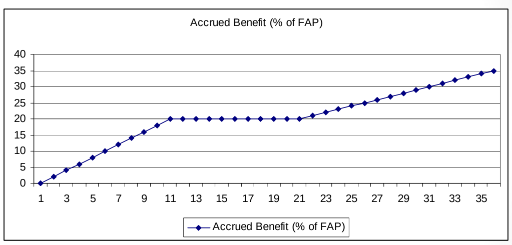
Backloading



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COMMON ERRORS

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Scrivener's Error

- When plan is reduced to writing, the lawyers often get it wrong.
- Plan sponsor **<u>thinks</u>** of this as "scrivener's error."
- However, in most cases, plan must be administered according to its terms. Scrivener's error is available in very limited circumstances.
- Example: Plan credits all service with "Employer" for benefit purposes, but only certain divisions actually participate in Plan.

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Incorrect data

- Missing years of service before participation in the plan
- Missing certain hours (FMLA, maternity leave, etc.)
- Missing components of compensation (certain bonuses, overtime)
- Missing service before rehire
- Missing union covered service
- Wrong date of birth, date of hire

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Compensation Errors

- Plan documents must define compensation used in benefit formula
- Compensation generally includes base pay or wages and may include:
  - Overtime pay
  - Premiums for shift differential
  - Bonuses
  - Commissions and incentive pay
  - Severance payments
- Common errors
  - Exclusion of all bonuses when only some are excluded by plan
  - Multiplying pay codes not reflected in plan document
  - Treatment of deferred compensation or pre-tax contributions
  - Awards, special compensation
  - Inconsistent treatment among employees

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Mergers and acquisitions

- Acquiring company fires HR staff, new staff throws out old boxes.
- Often pension plans are merged and only summary data is transferred to new plan.
- Companies lose track of former employees and fail to credit service when they are rehired.
- Grandfathered minimums are forgotten.

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Service outside the plan

- Employee works for Sub A, terminates, gets job at Sub B (example: KFC, Burger King). Will Sub B credit that prior service for participation, vesting, etc.?
- Service in hourly position where only salaried employees are eligible.

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Plans freezes and other amendments

- Failure to issue 204(h) notice
- Plan amendments never signed
- Failure to grandfather 411(d)(6) protected benefits

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Actuarial equivalence factors

- "Old" actuarial factors must generally be preserved with respect to accrued benefits when factors are changed.
- Especially when factors are included in an appendix, factors may accidentally be changed without preservation of prior factors.

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Questions

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