

KELLY, HANNAFORD & BATTLES P.A.

ANTHONY R. BATTLES
JULE M. HANNAFORD IV
A. DAVID KELLY
JOHN W. HAINE
SONJA LEMMER MARTENS

MARK D. MEYER
OF COUNSEL

ATTORNEYS AT LAW
3900 CAMPBELL MITHUN TOWER
222 SOUTH NINTH STREET
MINNEAPOLIS, MINNESOTA 55402
TELEPHONE (612) 341-0881
FACSIMILE (612) 341-1041

WRITER'S DIRECT DIAL:
612/455-6075
DKelly@KHBlaw.com

March 23, 2004

Re: New Requirements When a Defined Benefit Pension Plan Pays Benefits Retroactively

Dear Clients and Other Friends:

Effective in 2004, new requirements apply when a defined benefit pension plan pays a pension with a retroactive start date. In our experience, retroactive pension start dates typically occur under these circumstances:

- Employee retires unexpectedly and there isn't time to do benefit calculations and required paperwork until after her desired pension start date.
- Pension calculations are completed and benefit election forms are provided to terminating employee prior to desired pension start date, but he does not get around to signing the forms until later.
- Disability pension is delayed while employer obtains medical evidence that employee is disabled; once disability is confirmed, pension is paid retroactive to onset of disability.
- Employer is unable to locate a former employee who is eligible for a pension; he turns up later and wants his pension to be paid retroactively.

In all of these cases, there are legitimate reasons to allow a retroactive start date. Typically, the retroactive payment is a lump sum "make-up amount" reflecting the pension checks that were missed. Regular monthly pension checks are paid thereafter.

The IRS did not previously have any specific rules about how to handle qualified joint and survivor annuity elections in such situations. The new regulations fill that gap.

Short delays in beginning the pension. When the information about benefit options is provided to a participant before the desired annuity starting date but the participant does not sign and return the election forms until shortly after that date, the plan is free to issue any missed pension checks after the election forms are returned, so long as payment commences within 90

days after the information about benefit options was provided to the participant.¹ In such cases, the plan is not required to go through the additional procedural requirements outlined below.

Longer delays. When the participant does not complete the benefit election until more than 90 days after the optional settlement information was provided, or if the participant did not receive the optional settlement information until after the desired start date, the plan can allow a retroactive start date only if the following requirements are met:

- **Notice Requirements.** Before electing a retroactive start date, a participant must be provided all of the information about benefit options that is normally provided to participants before their pensions begin. This information must be provided no less than 30 days and no more than 90 days before the makeup amount is paid. If the information was provided previously, but the participant did not respond in time so that the 90-day deadline could be met, the information must be updated and a new notice must be given to the participant within 30 to 90 days before the date the makeup amount will be paid.²
- **Spousal consent.** If the Participant is married and the benefit is being paid in a form other than a qualified joint and survivor annuity, the payment election is subject to consent of the participant's spouse. Identity of the spouse is determined as of the date the makeup payment is paid rather than as of the retroactive start date. For example, if a participant receives a makeup payment in November 2004 for a pension retroactive to February 2004, the individual's spouse is determined in November rather than in February. Spousal consent is not required if the pension is being paid in a form that is a qualified joint and survivor annuity and the amount payable to the spouse upon the participant's death is at least equal to the amount which would have been paid under a qualified joint and 50% survivor annuity beginning as of the actual payment date rather than the retroactive start date.
- **Interest on Retroactive Payments.** The plan must pay "appropriate interest" on the pension payments that were delayed. The regulations do not specify the amount of interest that would be "appropriate". Apparently, this can be decided by the employer. We think it would be desirable to specify the interest rate (or procedure for setting the rate) in the Plan document. In our experience, this interest requirement is the most significant way the new regulations depart from past practice.
- **Cashout Amount.** If the entire benefit is being cashed out, the calculation of the lump sum value must be the greater of the value as of the retroactive start date or the value as of the actual payment date. If the plan allows participants to elect lump sum

¹ The regulations allow the 90-day deadline to be extended for "administrative delay" – for example, if the participant returns the election forms within 90 days but the first pension check is issued somewhat more than 90 days after the benefit information was provided. Regulations that have not changed continue to prohibit payment sooner than 30 days after the benefit information is given unless the participant and spouse consent, in which case the 30 days can be reduced to as little as 7 days.

² As noted in footnote 1, a plan can allow a participant and spouse to waive the 30-day requirement and receive the make-up amount as soon as 7 days after the information is provided.

cashout of a pension with a retroactive start date, this rule gives them an opportunity to game the retroactive start date rules in cases where interest rates have changed. (That is, if interest rates have risen and the cashout amount today is less than it would have been a year ago, a participant could elect a retroactive start date and get the benefit of the lower interest rate - and higher lump sum amount - he could have received back then.) We think that in response it would be reasonable for employers to prohibit lump sum distributions with retroactive start dates and limit the retroactive start opportunity to cases where the individual wants to receive a monthly pension. The regulations clearly allow such restrictions.

- **Code § 415 Limit.** If the retroactive start date is more than 12 months earlier than the actual start date, or if the pension is being paid as a lump sum, the Code § 415 limits must be satisfied as of the actual payment date, as well as the retroactive starting date. Under other circumstances (i.e. makeup amount paid within 12 months after retroactive start date and pension will be paid in monthly installments), § 415 compliance is measured only as of the retroactive start date.

These regulations apply to defined benefit pension plans for plan years beginning in 2004. They do not apply to 401(k) or other defined contribution plans. If you want to use these rules, you must amend your pension plan to so provide, and you should fine tune your procedures to make sure that you are following the new requirements. Let us know if you want our help with these requirements.

Sincerely,

A. David Kelly

ADK/jks