Pensions & Retirement Plans

Contributing editors
Steven J Friedman and Melissa B Kurtzman

2016

GETTING THE DEAL THROUGH

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Statutory and regulatory framework

1 What are the main statutes and regulations relating to pensions and retirement plans?

The main statutes and regulations relating to pensions and retirement plans are:

- the Internal Revenue Code of 1986 (Code);
- the Employee Retirement Income Security Act of 1974 (ERISA);
- the Treasury Regulations; and
- the Department of Labor Regulations.

2 What are the primary regulatory authorities and how do they enforce the governing laws?

Internal Revenue Service (IRS)

The IRS audits plans for compliance with tax-based laws. Enforcement occurs largely through penalties and excise taxes imposed on plan sponsors. There are also voluntary programmes that permit plan sponsors to bring compliance errors to the attention of the IRS and remedy problems in a cost-effective and non-punitive manner. Plan disqualification is rarely invoked for other than very serious offences; if it is, employees may be immediately taxed on the value of all plan benefits that have accrued to them and that would otherwise be tax deferred until distribution. Disqualification also results in a disallowance of tax deductions taken by employers on employer contributions. More common than actual disqualification, the IRS may base a penalty on a percentage of the amount of additional taxes it would have collected had it disqualified the plan.

Department of Labor (DOL)

The DOL audits plans for compliance with non-tax rules, often grounded in fiduciary standards required of plan administrators. The DOL may impose penalties on fiduciaries or subject them to various excise taxes.

Pension Benefit Guaranty Corporation (PBGC)

The PBGC collects fees from sponsors of defined benefit pension plans, which vary depending upon the adequacy of the funding status of the plan. The PBGC guarantees pension benefits to plan participants to a limited degree if plans become insolvent. The PBGC also has the authority to require funding of plans in poor financial condition and can also take over or shut down a plan.

3 What is the framework for taxation of pensions?

Broad-based plans are generally 'tax qualified', meaning that contributions to the plan are deductible by an employer, up to statutory limits, while the employee or participant is not currently taxed on the value of his or her plan benefit. The participant or beneficiary of such a plan, however, does pay income tax on his or her benefits when they are paid. A pension payout is generally taxable as ordinary income rather than capital gain (with a special exception for certain distributions of employer stock).

State pension provisions

4 What is the state pension system?

The system is called Social Security and is funded with contributions from employers and employees throughout the employee's working life. The system provides defined benefits to an employee and his or her spouse during their lifetimes. If an individual has no income other than social security, the payments will not be taxable. The taxable amount depends upon other income earned and marital status.

5 How is the state pension calculated and what factors may cause the pension to be enhanced or reduced?

The calculation of social security is complicated and requires the inputting of wages for one's entire working life into a computation that will vary depending upon the age of the employee at the time benefits commence. If payments are being made to a surviving spouse or child, they will be reduced from the payout amount to the employee.

6 Is the state pension designed to provide a certain level of replacement income to workers who have worked continuously until retirement age?

No.

7 Is the state pension system under pressure to reduce benefits or otherwise change its current structure in any way on account of current fiscal realities?

Yes. There is little doubt that without reform the current level of benefits will not be sustainable. It is expected that any reform of the social security system will lead to political battles and few expect reform to be a simple task. The system as now in place provides benefits to current recipients that are far in excess of the actuarial value of the contributions made on their behalf. The fear of future insolvency for this system is largely because of the ageing of the US population, longer life expectancy as well as insufficient levels of funding. Reform proposals have discussed lowering benefits, means testing and taxing benefits for wealthy individuals.

Plan features and operation

8 What are the main types of private pensions and retirement plans that are provided to a broad base of employees?

The most common form of plan is a defined contribution plan called a 401(k) plan. A 401(k) plan allows participants to defer a portion of their pay, generally on a before-tax basis, up to an annual limit (in 2016 the limit is US$18,000 for all, with those aged 50 and over permitted to defer up to an additional US$6,000). Often, an employer will choose to make a 'matching' contribution on the participant's behalf, with the amount dependent upon the level of the participant's pay deferral. The most common matching contribution is a contribution of 3 per cent of pay provided the participant defers 6 per cent of pay. An employer may also make a 'profit-sharing contribution' (not necessarily related in any way to the employer's profit levels) to all those eligible to participate in the plan, commonly allocated to eligible participants as a percentage (eg, 2 or 3 per cent) of a participant's annual compensation. It is permissible for employers to make matching contributions or profit-sharing contributions on a discretionary basis, where the employer makes a determination annually as to whether to make such a contribution and, if a contribution is to be made, the amount of the contribution. Generally, employees are permitted to direct the investment of their accounts in a 401(k) plan, choosing from among a set of investments established by the employer.

Defined benefit plans are no longer common in the US owing to high costs and unpredictable funding levels. Funding levels have improved a bit in recent years with the improvement in stock market performance, and defined benefit plans are still offered by some large employers, as well as many cities and states that are obligated to provide these plans to certain unionised employees under the terms of their collective bargaining agreement. Many defined benefit plans have been terminated or frozen and new plans often have not taken their place. Many employers may replace a defined benefit plan with a modest increase in the level of contributions under a defined contribution plan.

In other cases, defined benefit plans have been converted into cash balance plans, which are technically a type of defined benefit plan, but with a benefit that mimics a defined contribution plan. Such a plan provides for annual contributions at a specified percentage of compensation, and for growth at a defined interest rate established by the plan sponsor.

9 What restrictions or prohibitions limit an employer's ability to exclude certain employees from participation in broad-based retirement plans?

Qualified plans must pass 'non-discrimination tests', which seek to assure that a broad cross-section of the workforce is offered the opportunity to participate in the plan. There are also rules that do not permit highly paid employees (generally those earning over US$120,000) to defer a much greater amount than lower-paid employees into 401(k) plans. Similarly, matching and other employer contributions are required to be made in a manner that does not discriminate in favour of highly compensated employees beyond certain permitted levels.

10 Can plans require employees to work for a specified period to participate in the plan or become vested in benefits they have accrued?

Plans are permitted generally to require employees to work for one year and accrue 1,000 hours of service credit prior to allowing participation. Plans may impose vesting schedules in which a certain period of service must be reached prior to which plan benefits (other than those contributed by an employee) will be forfeited if the employee terminates employment. A 'cliff' vesting schedule of up to three years or a 'graded' schedule of up to six years can be imposed.

11 What are the considerations regarding employees working permanently and temporarily overseas? Are they eligible to join or remain in a plan regulated in your jurisdiction?

An employee who is seconded to a non-US employer generally can remain on US benefit plans. It is not unusual for US expatriates to remain on US benefits where the assignment is temporary. The determination of whether to be covered under the US plans may follow whether the employee will be subject to non-US Social Security during the assignment and whether there is a totalisation agreement in place between the US and the country of assignment. A rule of thumb used, which follows totalisation rules, is that an assignment of greater than five years will result in the employee being 'localised' and consequently receiving local benefits. If an employee works directly for a non-US affiliate, they cannot participate in a US plan unless that affiliate becomes a 'participating employer' in the plan, which is rare.

12 Do employer and employees share in the financing of the benefits and are the benefits funded in a trust or other secure vehicle?

Most employers share the burden of financing benefits with the employees. 401(k) plans, which are the most popular type of retirement plan, provide a mechanism for employees to divert a portion of their pay into the plan and the most common type of employer contribution, a matching contribution, will only be made if the employee has contributed their own pay. There may also be employer profit-sharing contributions, as described above, which do not require any employee contribution. Defined benefit plans generally provide for benefits funded solely by the employer but these plans are rare and becoming rarer. All broad-based retirement plans are required to be funded using a trust.

13 What rules apply to the level at which benefits are funded and what is the process for an employer to determine how much to fund a defined benefit pension plan annually?

There are complex rules in the US relating to funding levels that must be maintained with respect to defined benefit plans. Actuaries use assumptions that take into account expected rates of return on plan assets, employee demographics, interest rates, turnover and life expectancy to determine appropriate funding levels.

14 What are customary levels of benefits provided to employees participating in private plans?

Under defined contribution plans, employer benefits are generally matching contributions, which match at a particular level of employee pay deferrals (eg, 100 per cent of an employee's contribution up to 3 per cent of pay deferred or 50 per cent of an employee's contribution of 5 per cent of pay deferred) or profit-sharing contributions. Matching generally provides for maximum contributions of between 3 and 6 per cent of pay deferred. Profit-sharing contributions are often set at between 2 and 4 per cent of compensation. Profit-sharing is often a misnomer, as these contributions, generally, are not tied to levels of profitability.

Defined benefit plans generally provide for accruals of between 1 and 2 per cent of final average pay per year of service with the employer.

Cash balance plans often provide benefits of about 5 per cent of compensation per year.

15 Are there statutory provisions for the increase of pensions in payment (pension escalation) and the revaluation of deferred pensions?

No.

16 What pre-retirement death benefits are customarily provided to employees' beneficiaries and are there any mandatory rules with respect to death benefits?

The pre-retirement death benefits available under a retirement plan depend on the type of plan involved. Defined benefit plans and certain defined contribution plans (those subject to the Code's funding standards, such as money purchase pension plans and target benefit plans) are required by law to provide a pre-retirement survivor annuity to spouses of participants. Many of these types of plans will also pay some form of death benefit to designated beneficiaries of unmarried participants. Many plans also offer more generous survivor benefits than those required by law.

Other defined contribution plans (including 401(k) plans) are also subject to the pre-retirement survivor annuity rules unless the participant's vested account balance is payable in full to the participant's surviving spouse or to the participant's designated beneficiary (if the spouse consents or if there is no spouse). Most defined contribution plans not subject to the Code's funding standards are designed to avoid being subject to the survivor annuity rules, meaning that beneficiaries receive 100 per cent of the participant's vested account balance upon the participant's death. These plans also typically provide that a participant's account balance will become fully vested upon death, so the beneficiaries ordinarily do not lose any benefits.

17 When can employees retire and receive their full plan benefits? How does early retirement affect benefit calculations?

It depends on the type of plan involved and the specific terms of the plan. Retirement plans can provide for a 'normal retirement age', at which time participants are fully vested and permitted to retire and receive their full plan benefits. Some plans, primarily defined benefit plans, also provide for an early retirement age at which participants can begin receiving benefits.

Early retirement benefits in a defined benefit plan are often subject to a reduction determined by a formula set forth in the plan in order to account for the likely increased payment period. Early retirement benefits must be at least actuarially equivalent to the participant's accrued benefit at normal retirement age, but many defined benefit plans provide more generous early retirement benefits. For example, a plan may provide that participants electing to retire early will have their benefits reduced to 3 per cent per year for each year prior to the normal retirement age their benefits begin, even though the actuarial reduction would be larger.

Under defined contribution plans, a participant is generally eligible to receive a distribution of the account balance, to the extent vested, upon termination of employment regardless of whether he or she has attained normal retirement age. If a participant terminates employment before becoming fully vested in the plan, a portion of his or her benefit will be forfeited.

18 Are plans permitted to allow distributions or loans of all or some of the plan benefits to members that are still employed?

Yes. Defined contribution plans are permitted to allow loans.

The permissible in-service distribution options depend on the type of plan involved and the plan design selected by the plan sponsor. For example, 401(k) plans can only allow distributions to active employees on account of hardship, when the participant reaches 59 and a half, for qualified reservist distributions, or when the plan is terminated. Profit-sharing plans, however, can permit distributions after employer contributions have been in the plan for at least two years, or after the employee has participated in the plan for at least five years. Plans are not required to permit any in-service distributions, but most typically do.

Additionally, recent changes in the Code allow pension plans to permit in-service distributions when a participant reaches 62. Similar to defined contribution plans, permitting in-service distributions is optional. Defined benefit plans may not offer hardship withdrawals, and typically do not allow participant loans.

19 Is the sufficiency of retirement benefits affected greatly if employees change employer while they are accruing benefits?

The effect of changing employers on retirement benefits depends primarily on whether the individual becomes fully vested before changing employers and the type of plan that the employee is participating in. If the employee becomes fully vested before changing employers, under a defined contribution plan, the employee will not lose any of the employee's retirement benefit earned with the previous employer. If the employee is not fully vested at the time the employee changes employers, the employee could have some or all of the employee's retirement benefit attributable to employer contributions forfeited. Under a defined benefit plan, because the benefit accrual formula is often dependent upon the employee's years of service and final average pay, a change in a participant's employment can affect benefit accruals adversely as the pay component will be measured at the time of termination and future pay increases will not increase the benefit under the former employer's plan.

Sufficiency of retirement benefits could also be affected if the plan of the employee's new employer does not allow immediate participation. Retirement plans are permitted to require one year of service (or two years, if the employee is fully vested upon entering the plan) before allowing an employee to participate. The employee could contribute to the employee's individual retirement arrangement or individual retirement account (IRA) even if not eligible for the new employer's retirement plan, but the retirement plan will often provide an opportunity to accumulate a greater retirement benefit than the employee could build through contributions to an IRA.

20 In what circumstances may members transfer their benefits to another pension scheme?

Employees can transfer their benefits to another pension plan if they receive an 'eligible rollover distribution' and the proposed recipient plan accepts 'rollovers.' An eligible rollover distribution is any distribution from a qualified retirement plan except the following:

- a distribution that is one of a series of substantially equal periodic payments for either the life of the employee or a specified period of at least 10 years;
- a required minimum distribution; or
- a hardship distribution.

Most employer-sponsored retirement plans will also accept rollovers, but such plans are not required to accept them. In addition to being able to transfer an eligible rollover to another pension plan, employees are also able to deposit eligible rollover distributions into an IRA.

21 Who is responsible for the investment of plan funds and the sufficiency of investment returns?

It depends on the type and design of the plan. In defined benefit plans, a fiduciary of the plan generally takes responsibility for the investment of plan assets. The fiduciary may be a trustee, administrative committee, or other fiduciary named in the plan or trust document. The fiduciary responsible for investment may also delegate this duty to a designated investment manager. If the assets of a defined benefit plan are not sufficient to pay all benefits called for under the plan, the employer will need to make up the deficiency.

In defined contribution plans, participants are generally responsible for selecting the particular investments for their accounts. A plan fiduciary will designate investment alternatives from which the participants may choose. Although participants have the right to select investments, the plan's fiduciaries will have responsibility if it is shown that the fiduciary failed to make appropriate investments available to the participants consistent with the fiduciary duties required under ERISA of such plan fiduciaries. In some defined contribution plans, a plan fiduciary will be responsible for investment of plan assets, but such arrangements have become very rare in the current retirement plan environment.

22 Can plan benefits be enhanced for certain groups of employees in connection with a voluntary or involuntary reduction in workforce programme?

Yes, subject to some limitations. The Code prohibits qualified retirement plans from providing benefits that discriminate in favour of highly compensated employees (meaning employees earning compensation over a certain limit, which is US$120,000 for 2016 and is adjusted annually). If the enhanced retirement benefits are given only to highly compensated employees, or highly compensated employees are treated more favourably, then the qualified status of the plan would be jeopardised.

23 Are non-broad-based (eg, executive-only) plans permitted and what types of benefits do they typically provide?

These types of plans are permitted. They often provide benefits similar to those offered under qualified retirement plans, such as defined contribution-type individual accounts, or defined benefit-type retirement benefits and are sometimes expressly designed as a supplement to a qualified plan. Additionally, while not technically treated as retirement plans, executives often participate in plans that provide various forms of equity-based compensation, such as stock options, restricted stock, stock appreciation rights and phantom stock rights, which arrangements are not subject to the non-discrimination rules applicable to qualified plans.

24 How do the legal requirements for non-broad-based plans differ from the requirements that apply to broad-based plans?

Non-broad-based plans are not subject to the Code's qualification requirements that apply to broad-based plans, including non-discrimination, minimum coverage, section 415 annual addition and benefit accrual limitations, and trust requirements. Plans that provide for taxable benefits to be paid on a deferred basis that are not broad-based qualified plans, however, are subject to section 409A and other tax provisions, which limit how and when benefits may be provided, and prohibit such arrangements from being 'funded' (meaning that funds to pay such benefits must not be placed outside the reach of the employer's creditors). If a non-broad-based plan offers retirement-type benefits, the plan will also be subject to ERISA, but will generally be exempt from ERISA's reporting and disclosure requirements and will not be subject to ERISA's funding, vesting and fiduciary rules.

25 How do retirement benefits provided to employees in a trade union differ from those provided to non-unionised employees?

This depends primarily on the benefits for which the union has bargained and to which the employer has agreed. Some unions bargain for inclusion in the employer's retirement plans on the same basis as non-union employees. Other unions bargain for participation in a multi-employer pension plan. The industry in which the union employees work and the benefits currently offered by the employer will affect what benefits the union will seek.

26 How do the legal requirements for trade-union-sponsored arrangements differ from the requirements that apply to other broad-based arrangements?

Collectively bargained plans automatically pass minimum coverage and non-discrimination testing, with the exception of special non-discrimination testing for 401(k)-type plans. For other requirements, a single-employer collectively bargained plan would generally be subject to the same rules as a non-collectively bargained plan. If a plan contains both collectively bargained and non-collectively bargained employees, the portion of the plan benefiting collectively bargained employees can be treated as separate from the other portion of the plan for purposes of minimum coverage and non-discrimination testing.

An employer contributing to a multi-employer pension plan, which is by definition a collectively bargained plan, is typically not responsible for administering the plan. In addition to required contributions, a multi-employer plan that is an underfunded defined benefit plan will impose withdrawal liability upon an employer who ceases to make contributions.

Enforcement

27 What is the process for plan regulators to examine a plan for periodic legal compliance?

An examination of a plan by regulators generally begins with a notification from the applicable agency of the examination and a request for documents and other information relating to the plan. The agent will usually conduct an on-site examination, and the initial request will direct that the listed documents and information be available during the on-site investigation.

After the on-site examination, the agent will either issue an additional request for information or will discuss with the plan sponsor and the sponsor's counsel any compliance issues discovered, permissible methods to resolve them and what penalties may be imposed. The agent will issue these findings in writing and identify the amount of the penalty, if any.

The plan sponsor and the agent will then typically work together to resolve any disagreement the plan sponsor may have with the agent's findings. If the parties are unable to come to an agreement, the plan sponsor may request additional administrative review in accordance with the respective agency's procedures.

28 What sanctions will employers face if plans are not legally compliant?

The sanctions employers could face depend primarily on the agency examining the plan, how serious the compliance issues are, and the steps the employer takes to address compliance issues promptly.

Penalties imposed by the IRS are generally based on a negotiated percentage of what the IRS refers to as the 'maximum payment amount'. The maximum payment amount is approximately the amount of all tax the IRS could collect for all open years upon disqualification of the plan, including tax on the trust, additional income tax resulting from the loss of employer deductions for plan contributions, and additional income tax resulting from income inclusion for participants in the plan. The IRS will subjectively review several factors in determining the amount of the sanction. Additionally, depending on the compliance failures, the plan sponsor may be subject to an excise tax, for example, on non-deductible contributions or on prohibited transactions.

Penalties imposed by the DOL will depend on the type of failure discovered, and only a few examples are provided here. For example, if a prohibited transaction occurred, the DOL will require that the transaction be corrected, that any lost earnings be returned to the plan, and may assess a 5 per cent penalty against the parties involved in the transaction. Additionally, the DOL has authority to impose civil penalties for the failure to file a Form 5500 (a required annual report). The DOL is authorised to impose a penalty of up to US$1,100 per day for a plan administrator's failure to file a Form 5500, with no maximum. The DOL generally will not impose such a high sanction, but has the legal authority to do so. If a fiduciary breach occurred, the DOL also has the authority to impose a civil penalty of up to 20 per cent of the amount recovered by the DOL on behalf of the plan with respect to the breach.

29 How can employers correct errors in plan documentation or administration in advance of a review by governing agencies?

Both the IRS and DOL have established voluntary correction programmes. Under the IRS correction programme, a plan sponsor can correct certain operational failures on its own without notifying the IRS. Other errors require corrections subject to IRS approval. When the IRS approves the correction method, the IRS will not assert a qualification failure with respect to the corrected issue in a future audit.

The DOL's correction programmes require a submission to the DOL. Once the correction is accepted, the DOL will issue a letter informing the plan sponsor that the DOL will take no administrative action with respect to the error.

30 What disclosures must be provided to the authorities in connection with plan administration?

The primary disclosure to federal regulators is the IRS Form 5500 Annual Report. Most retirement plans are required to submit an IRS Form 5500 to the IRS and DOL annually. The plan sponsor discloses on the Form 5500 information regarding the number of participants, types of benefits provided, financial statements for the plan, and other general compliance issues (eg, whether any participant contributions were deposited in the plan late, or whether the plan is covered by a fidelity bond). For plans with more than 100 participants, the plan is also required to be audited by an independent accounting firm.

For individually designed retirement plans (ie, not prototype or volume submitter plans), the IRS has established five-year restatement cycles, during which time the plan sponsor should submit a restated retirement plan to the IRS for review. If the form of the plan satisfies the qualification requirements, the IRS will issue a determination that the plan is qualified based on its terms.

The Pension Benefit Guaranty Corporation, which insures defined benefit pension plans, also requires sponsors of defined benefit plans to make a filing along with their annual premium payment to the PBGC. Large plans (500+) participants must also make an estimated flat-rate premium payment with supporting filing to the PBGC. Other PBGC reporting requirements may arise depending on events affecting the plan or the plan sponsor.

Additional disclosures will typically be required in the course of an examination of the plan by federal regulators.

31 What disclosures must be provided to plan participants?

Among the most important general disclosure requirements are:

- summary plan descriptions, which are designed as 'plain-language' guides to plan terms;
- summary annual reports setting forth certain financial information about defined contribution retirement plans;
- annual funding notices regarding the financial condition of defined benefit plans; and
- information about plan service providers, which focuses on the nature of provided services and the compensation received by the individuals and entities providing them.

The most important circumstance-based disclosures include:

- a Notice of Significant Reduction in Future Benefit Accrual, in the case of amendments to defined benefit plans and certain defined contribution plans that will stop accruals or decrease the rate at which benefits accrue in the future;
- a Notice of Blackout Period, where participants' ability to direct investments, obtain loans, or receive distributions in defined contribution plans will be limited for a period of time;
- disclosures with regard to employer stock required under securities laws; and
- '404(c) disclosures', for plans in which participants have the ability to direct their investments; this information relates to the available investments and how participants exercise their rights to direct.

32 What means are available to plan participants to enforce their rights under pension and retirement plans?

ERISA requires plans to have internal administrative claims and appeal procedures that are designed to be a participant's first recourse in the case of any dispute. For claims under the plan's internal claim procedures, a designated fiduciary considers the participant's request and, if the fiduciary disagrees, the claim decision must communicate certain detail to the participant about the reasons for the denial. In connection with the claim, the participant also has rights to information from the plan that may help the participant understand the reasoning of the fiduciary and pursue additional avenues for resolution of the dispute.

If the participant disagrees with the initial determination regarding their claim, the participant may appeal, also pursuant to the plan's claims procedures, and will have an opportunity to present their position to a fiduciary (which may be the same fiduciary that decided the claim) and review information that the plan has gathered.

After the internal administrative procedure has been completed, the participant can sue the plan in the federal courts.

Plan changes and termination

33 What restrictions and requirements exist with respect to an employer's changing the terms of a plan?

The plan document itself may limit the employer's ability to amend certain provisions; although, customarily, an employer reserves the full legal right to make changes.

The legal restrictions are set forth in ERISA. An employer may not reduce the 'accrued benefit' of a participant or take away vested rights.

Update and trends

The US Department of Labor recently published a rule that expands the scope of who is considered a fiduciary of a retirement plan. This rule not only imposes new requirements on investment advisers and others who manage plan funds but also clarifies the oversight obligations of employers who sponsor retirement plans.

The accrued benefit in a defined benefit plan includes the right to the normal retirement age benefit as described in the plan. In addition, accrued benefits include early retirement benefits, retirement-type subsidies and optional forms of benefit. To the extent that a participant either qualifies for an early retirement benefit or retirement-type subsidy at the time of the amendment, or subsequently earns that right owing to future service, the right cannot be taken away. The protection with respect to optional forms of benefit limits the employer's ability to eliminate a form of benefit with respect to benefits earned as of the date of the amendment.

For defined contribution plans, an amount is an 'accrued benefit' when it is deposited in the participant's account. Plan language needs to be considered, however, to determine whether an amount that has not yet been deposited is protected because the amount already should have been deposited.

34 What restrictions and requirements exist with respect to an employer terminating a plan?

Again, the plan document needs to be reviewed to determine whether additional protections are included, although most employers reserve the right to terminate a plan to the maximum extent permitted by law. A plan termination, like a plan amendment, cannot result in a participant's losing a right to benefits accrued at the date of termination. In addition, termination of a defined contribution plan or a defined benefit plan will, to the extent of existing funding, cause unvested benefits to become vested. For plans subject to the notice requirements related to future curtailment of benefits (eg, defined benefit plans), those notice requirements will also apply to a plan termination.

Terminations of defined contribution plans are relatively straightforward. Appropriate authorising resolutions need to be adopted, and, depending on the type of plan, benefits will either be distributed or will be transferred to another plan of the employer. In most cases, benefits are distributed.

Termination of a defined benefit plan also requires that filings be made with the Pension Benefit Guaranty Corporation and that the PBGC's process be followed. A defined benefit plan may be terminated in either a 'standard' or 'distress' termination.

35 What protections are in place for plan benefits in the event of employer insolvency?

Because a retirement plan is a separate legal entity that is funded in a trust that is independent of the employer, or an insurance contract, the insolvency of the company does not necessarily cause any financial impairment of the plan. Practically, companies that are in trouble financially may have created some financial uncertainty in their plans. Where a defined benefit plan is underfunded, however, the insolvency of the employer may mean that employer contributions will not be available to make up the deficiency in funding. In such a case, PBGC insurance may pay benefits that cannot be paid from the plan's trust, but that insurance will not necessarily provide the full pension benefit because of limits on the level of pension benefit that is insured.

In the case of both defined benefit plans and defined contribution plans, financial uncertainty for a company may cause it to fail to make required contributions to a plan. In those cases, the government, participants, or plan fiduciaries can bring suit in an effort to secure at least some of the money that should have been deposited in the plan.

36 How are retirement benefits affected if the employer is acquired?

Because a plan is a separate legal entity, the acquisition of an employer, by itself, does not necessarily cause benefits to be affected. In transactions, employers will typically consider whether acquired company plans will be terminated, frozen as to future benefits (with existing benefits preserved) or combined with comparable plans of the acquiring company. In asset transactions, plans may even be left behind and maintained on a frozen basis by the seller. While a variety of factors may lead to a decision in this regard, the continuation of a plan after an employer is acquired is more likely to occur in a stock transaction, because, in that case, the sponsoring entity continues intact.

37 Upon plan termination, how can any surplus amounts be utilised?

There is rarely a surplus upon termination of a defined contribution plan, because the general allocation rules require that all assets be in participants' accounts.

Defined benefit plans may have funding surpluses (although that is unusual in the current low interest rate environment, as low rates cause liabilities to increase). The ways in which excess assets can be used is, however, very limited. Excess assets can be paid to participants, used to fund retiree health accounts, transferred to a successor plan, or used to increase benefits in the terminating plan. If the employer does not use surplus assets in one of these ways, an excise tax will cause most of the surplus to be paid to the government.

Fiduciary responsibilities

38 Which persons and entities are 'fiduciaries'?

ERISA provides that the following are fiduciaries:

- anyone who exercises discretionary authority or control with regard to plan management or authority or control with regard to plan assets;
- anyone who has discretionary responsibility with regard to plan administration;
- anyone who renders investment advice for a fee or has authority to do so; and
- an investment manager who has accepted fiduciary responsibility.

Typical fiduciaries include plan trustees and plan administrators. The scope of who is considered a fiduciary will broaden in 2017 when new rules become effective. At such time, fiduciaries will include a broader range of individuals who make recommendations related to plan investments.

39 What duties apply to fiduciaries?

The ERISA fiduciary duties include:

- the duty to administer the plan prudently;
- the duty to diversify plan assets;
- the duty to administer a plan consistent with its terms;
- the duty to administer a plan in the exclusive benefit of participants;
- the duty to monitor fiduciaries to whom duties have been delegated; and
- the duty in some circumstances to prevent breaches by other fiduciaries.

In addition, any fiduciary who engages in a transaction that is classified under ERISA as a prohibited transaction is in breach of his or her fiduciary duties. ERISA-prohibited transactions include self-dealing transactions and certain transactions between a plan and a 'party in interest.' This latter term includes the plan's fiduciaries and other persons related to the fiduciaries as well as the plan sponsor.

40 What are the consequences of fiduciaries' failing to discharge their duties?

A fiduciary that is liable to the plan for breach of fiduciary duty must disgorge any profit that the fiduciary made through the breach and must make the plan whole for the consequences of any breach. In addition, the fiduciary may be enjoined from future activities with respect to ERISA plans.

Legal developments and trends

41 Have there been legal challenges when certain types of plans are converted to different types of plan?

Legal challenges on plan conversions have occurred where traditional defined benefit plans have been converted to cash balance plans, which are pension plans that measure the amount of the benefit with reference to a hypothetical account balance. The basis for these lawsuits has been age discrimination (the contention that the cash balance plan treated older workers less favourably than traditional plans).

42 Have there been legal challenges to other aspects of plan design and administration?

Recent legal challenges are focused on two major areas:

- allegations that plan fiduciaries permitted the plan to pay excessive fees to vendors of plans (mostly in connection with plan investments); and
- allegations that plan fiduciaries permitted the continued offering of employer stock as a permitted plan investment when that stock was not prudent as an investment.

Many of the lawsuits in the first category resulted in significant settlement amounts in favour of plan participants and, in at least one case, resulted in a significant judgment against plan fiduciaries (liability plus fees and costs exceeding US$50 million). Lawsuits in the second category have also resulted in some significant settlements and judgments, although the developing doctrines are making it much easier for fiduciaries to defend those cases. Employers are paying greater attention to plan governance because of both heightened lawsuit activity as well as the DOL's frequent audit activity that focuses on plan fiduciary governance.

43 How will funding shortfalls, changing worker demographics and future legislation be likely to affect private pensions in the future?

Private pension trends strongly favour defined contribution plans with employees responsible for financing a significant part of their benefits. This has led to several regulatory actions aimed at ensuring additional information is made available to plan participants so they may better understand the potential risks and rewards of the investments available for their plan accounts.

Legislative and regulatory activity also focuses on providing increased flexibility to participants in defined contribution plans following termination of their employment, with some initiatives focused on portability and others on distribution alternatives that would permit participants to receive extended distributions over all of their retirement (as opposed to a single amount when they leave employment).

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