DEFINED BENEFIT PENSION PLANS: RECOUPMENT OF OVERPAYMENT

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ABSTRACT

The paper introduces some of the issues surrounding pension overpayments and looks at the issues from several different perspectives: the employer (or pension plan), the retirees who have received overpayments, future retirees vested in the pension plan, and the IRS. Students may find the recovery of defined pension benefit overpayments a very interesting topic to consider both from a standpoint of legal regulation, fairness, and ethics. The topic is certain to get a spirited discussion among the students as to who is at fault, who should remedy the situation, and what is fair for each party involved.

INTRODUCTION

Defined benefit pension plans are usually covered as a topic in Intermediate Accounting, often in the second semester. In covering this material, most texts and professors focus on the concepts of pension expense, including the components of pension expense; pension assets, including how they grow over time; and the projected benefit obligation, including the factors that increase this obligation over time (see for example, [7] [8] [9]). Many of the intermediate texts also cover briefly the concept of pension settlements and curtailments. Because of the many complex concepts involved, including time value of money calculations, students often struggle with the calculations for defined benefit pension plans. Perhaps at the conclusion of the pension coverage, the students could be introduced to the interesting topic of pension plan overpayments to retirees and the recovery of these payments once discovered. Ethical, tax, and fairness issues are involved, and teachers can let the students give their opinions at a surface level for a short period of time or allow the students to get into the more complex issues surrounding pension overpayments through an extended discussion. Since intermediate accounting textbooks seldom cover the actual payment of retirement benefits, it is unlikely that overpayments will come up unless the issue is specifically raised by the teacher.

The paper introduces some of the issues surrounding pension overpayments and looks at the issues from several different perspectives: the employer (or pension plan), the retirees who have received overpayments, future retirees vested in the pension plan, and the IRS. At this level of discussion, the topic will likely be a welcome diversion from the complex pension calculations while still allowing the students to exercise critical thinking skills and making ethical judgments. The students will likely find this discussion quite interesting, thus leading to strong opinions on how pension overpayments should be handled. While not addressed in this paper, the impact of overpayments on pension calculations and journal entries over an extended time period can also be added to the discussion, perhaps more appropriate in a graduate level class.

DEFINED BENEFIT PENSION PLANS

Defined benefit pension plans provide for retirement income to retired employees who are vested in the plan. The retirement benefits are usually paid based on some percentage of an employee's highest salary multiplied by the length of service an employee contributes under the plan. The highest salary may be calculated by the plan as an average, such as the average of the five highest salaries earned by the employee. Thus, defined benefit pension plans usually pay more to employees with higher salaries during their working years and to employees who have worked longer for the employer before retirement.

Because the employer is promising deferred compensation for an unknown length of time from the employees' retirement until they pass away, many assumptions must be made to estimate the future promised payments which are then measured at present value to determine the liability involved. Common sense would dictate that a company is also accumulating assets to provide for the future promised payments. In fact, to provide some security for employees with defined benefit plans, government regulations help employers determine minimum funding requirements. The federal government also provides a type of insurance for these types of pension plans through the Pension Benefit Guaranty Corporation.

When an employee retires, he/she may have different options as to how the promised benefits will be paid. A default option would just make payments to the employee based on the actual benefit formula defined in the plan. However, the employee may have other options that would provide for income to both the retiree and a spouse over the longer of both lives, perhaps with a reduction in benefits when the first of the couple passes away. Other options might exist such that the retiree can claim a specific amount for a guaranteed period of time, with a continuing benefit if he/she outlives the period of the guarantee. If the employee retires early, he/she may be able to start claiming pension benefits early but at a reduced amount.

AMOUNTS OWED AND OVERPAYMENTS

In society, we assume that both businesses and individuals will refund overpayments. For example, if a patient pays a co-payment at a doctor's office but the entire amount of the bill ends up being paid by insurance, the patient expects to receive a refund from the provider. If too much change is received for a cash purchase, we consider it honest to return the extra amount received. Some stores and online retailers will even guarantee to match a lower price within a certain time period if a product is purchased but the retail price decreases before the end of a certain period such as 90 days. While technically not an original overpayment, these retailers have promised to treat these amounts as overpayments and refund the difference. If a consumer continues to make installment payments on a purchase even after the purchase has been paid in full, the consumer expects to receive a refund for the amount of the overpayment. If a taxpayer files his/her income tax return for the prior year and discovers that withholdings and prepayments exceed the final income tax liability, he/she expects a refund for the overage.

Some overpayments may never be refunded if neither party involved ever recognizes the overpayment. Some overpayments are refunded after an extended period of time. Every once in a while, an individual may receive a refund for an overpayment that he/she didn't even recognize as having been an overpayment, perhaps an overpayment made many months or years previously. While the recipient may wish to have had the money earlier, if the money was unexpected, it usually comes as a pleasant surprise.

PENSION OVERPAYMENTS AND RECOUPMENT

What happens when a defined benefit pension plan makes overpayments to retirees, especially over an extended period of time? Pension benefit overpayments may be a result of different things such as miscalculation of benefits, failure to reduce benefits for a participant whose benefits should have been reduced under the plan for disability or Social Security benefits, failure to stop or reduce benefits if the participant is re-employed under circumstances that should have reduced the benefits, or the Pension

Benefit Guaranty Corporation takes over a plan and continues to pay benefits at the original level and later learns these benefits are over the guarantee limit [5].

What happens if the recipient may not have been given information about how the benefits were calculated and therefore has no idea that the overpayments are being received? What if these overpayments are received over a lengthy time period, perhaps years or decades? The recipient may become accustomed to the amount of the periodic pension payments received and either incorporate these payments into a higher standard of living or even require them for a modest standard of living, depending on other sources of retirement income.

Once the overpayment is discovered, what should happen? Technically, the recipient has been overpaid and owes the overage back to the pension plan. Overages have been recovered in different ways. Not only might a retiree's future pension payments be reduced to the corrected value, but the amounts may also be reduced to recoup some of the overpayment. In extreme cases where the pension plan does not expect to be able to recoup the overage through reductions in future benefits, the pension plan has billed the recipient for a lump sum for additional amounts owed. A recent report by CNN Money indicates that a specific union pension fund had overpaid 589 retirees over a 40-year period by $5 million. One of those retirees had his future pension benefits reduced but also received a bill from the pension fund asking for almost $67,000 as a lump-sum payment representing the amount the fund did not think it would be able to recover through reduced pension payments over his expected lifetime [1].

Pension plans have even been known to charge interest on the overage as it is repaid. If the overages have been paid to the retiree over many years, the interest can be a very significant amount, even more than the original overage. Is it fair for recipients to be forced to repay the overage if they are not at fault and had no reason to understand that overpayments were being received? What if the reduction in benefits or the repayment of a lump sum would create a financial hardship for the retiree?

While a liability may technically exist for the overpayment amounts, is it ethically sound to expect the retiree to repay these amounts? On the other hand, if the repayment is not made, is it ethically sound for the retirees who received overpayments to benefit to the detriment of future retirees for whom adequate pension assets may no longer exist? If the overpayment is the fault of the employer or pension plan, is there some responsibility attached to these entities to make good on the overpayments without requiring repayment from the retirees? What are the ethical ramifications of charging interest on the overpayments, especially if the recipient never even knew he/she was receiving too much and accumulating a large liability?

DISCUSSION

Students may give their opinions as to the rights and responsibilities, including ethical implications, for the parties involved: the employer/pension plan, the retirees who have been overpaid, future beneficiaries of the pension plan, and the IRS (and perhaps other federal government agencies such as the Pension Benefit Guaranty Corporation). The IRS may be a relevant party because defined benefit pension plans provide deferred compensation on a tax-favored basis. Thus, these plans must meet IRS requirements in order to continue to retain their tax status.

The employee/pension plan has the fiduciary responsibility to meet the contractual requirements of the pension plan, including the accumulation of assets to make the promised pension benefit payments and the payment of those benefits. It has a responsibility to reach an appropriate standard of care to avoid mistakes or correct them in a timely manner. It also has a responsibility to make sure the plan meets IRS guidelines and to keep the plan viable for future beneficiaries earning benefits under the plan. If the plan has made overpayments to retirees, it has a responsibility to determine how it can try to recover as much of the overpayment as possible, perhaps while also considering the harm this may cause to retirees or others.

Retirees have the responsibility to report overpayments if they are aware of them. This might imply another responsibility for the employer/pension plan to provide adequate documentation to the retirees as to the calculations used for determining pension benefits and documentation of what circumstances might require a change in the benefits. By educating retirees and reminding them of the pension benefits deserved, the pension plan might be able to get help from some of the retirees who could then report incorrect payments. Retirees may be responsible for repayment of some or all of the amount of the overpayment even if they were unaware of the error. However, retirees may understandably be upset if the repayment causes financial hardship. Even if they have the ability to repay the overpayments, they may be frustrated that they end up being penalized for getting used to a standard of living that can no longer be maintained because of an accruing liability of which they had no knowledge.

Other questions can arise from overpayments to retirees. Since the pension plan will report the pension payments as taxable income to the retirees, the retirees will have paid income taxes on the overpayments even though the overpayments were technically retiree liabilities instead of retiree income. When the overpayments are discovered, how are the corrections handled for tax purposes. If the overpayments are simply recovered through a reduction of future pension benefits, then the future taxable income and taxes would, in essence, be reduced because of the smaller pension payments. However, what if some of the overpayment is recovered through a lump-sum payment from the retiree? Even though this is technically the repayment of a liability, can it be deducted in some way on a tax return, at least to the extent it was previously included in income in prior years? It would seem that the retiree cannot file amended returns to reduce prior years' reported taxable income if the overpayments were received over an extended time period, as there is a short timeframe for which amended tax returns can be filed.

What if the overpayments affect other things than just a retiree's income tax returns? A specific case involving an employee injured on the job who started receiving pension payments at age 45 indicated that he was not only paying taxes on the overpayments, but that he was also paying child support payments on the overpayment amounts. How far would the court system go in allowing him to claim the overpayment on child support as an amount his wife owed back to him? She had no knowledge of the incorrect overpayments received for child support, but he also claims he had no knowledge of the incorrect overpayments received from the pension plan.

Future beneficiaries of a pension plan have the right for the plan to be well managed and maintained so that assets will be available to pay promised benefits. This would include the right for overpayments made from the pension plan to be recovered to protect the interests of these individuals.

Because defined benefit pension plans have tax-favored status, the IRS can expect that these plans will follow rules and guidelines to preserve the tax status. If mistakes are made, including mistakes of making overpayments, the IRS provides ways for these mistakes to be corrected. The IRS periodically updates the comprehensive system of correction programs for entities which sponsor tax-favored retirement plans. Revenue Procedure 2013-12 [3] gives the latest version of this system of corrections; this superseded the information found in Revenue Procedure 2008-50 [2]. Revenue Procedure 2015-27 [4] modified but did not supersede Revenue Procedure 2013-12. The technical details of these IRS documents are beyond the scope of this paper, but the most recent modification clarified that a pension plan which has made overpayments may be able to correct these overpayments in ways other than requiring the retirees to pay back the overpayment amounts.

Many arguments can be made with respect to pension overpayment and the fairness of collecting the overpayments from the retirees who received those overpayments. "The Pension Rights Center is a nonprofit consumer organization that has been working since 1976 to protect and promote the retirement security of American workers, retirees, and their families" [6]. The Pension Rights Center has proposed several policy provisions for both the Internal Revenue Service and the Department of Labor which would be friendlier to pension plan beneficiaries. Students could discuss each of these proposals, not only with respect to retirees, but also with respect to the other parties involved. Proposals for the IRS are as follows:

1. Only allow a three-year look-back period to correct errors rather than allowing/requiring the correction of errors that have been in place for decades.
2. Not allow pension plans to charge interest on the repayment of overpayments.
3. Put a cap on the pension benefit reduction amount of 10 percent.
4. End recoupment reductions once the overpayment amount has been paid.
5. Require plans to seek alternative sources of restitution (fiduciary insurance, employers, or third-parties that made the calculation errors) before seeking the overpayments from retires.
6. Prohibit the demands for lump-sum payments if reductions in future benefits will not repay the overages.
7. Do not allow collection of overpayment from other beneficiaries or alternate payees (besides surviving spouses who already are not liable for overpayments) [6].

The Pension Rights Center also suggested that changes be made to two other areas related to recoupment that are under the jurisdiction of the Department of Labor. These areas relate to hardship waivers and the claims/appeals process [6]. These proposals are also intended to make the process of recoupment friendlier to retirees.

CONCLUSION

The paper is in its preliminary stages, and many more details and factors could be added. However, students may find the recovery of defined pension benefit overpayments a very interesting topic to consider both from a standpoint of legal regulation, fairness, and ethics. The topic is certain to get a spirited discussion among the students as to who is at fault, who should remedy the situation, and what is fair for each party involved. After several days of discussion of detailed and complex calculations for defined benefit pension plans in an intermediate accounting class, this discussion might be an appropriate but temporary diversion on a related, relevant, and interesting topic.

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