For your information

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Evaluating Retiree Cash-out Windows

Recent IRS Private Letter Rulings confirm that qualified pension plans that are not terminating can offer participants who are currently receiving annuity payments a limited window of opportunity to exchange their remaining payments for a lump sum (or to switch to a qualified joint and survivor annuity or qualified optional survivor annuity) if the offer is made in connection with a plan amendment that "increases" benefits.

Pension plans that make these types of offers - *whether made for a retiree window, for a plan termination, or because benefit distribution restrictions are lifted when plan funding improves* - need to comply with other technical requirements applicable to pension benefit payments. These include requirements such as the minimum present value requirements for lump sums, the maximum benefit limitations under Section 415, the funding-based prohibited payment restrictions, and the nondiscrimination rules.

Background

Some employers have considered de-risking pension plan liabilities by offering former employees the option of a lump sum distribution. The settlement of the plan's liability to the individual participant removes the liability for future payments from the balance sheet at the cost of the amount paid. Similarly, liabilities can be settled by purchasing an annuity to transfer the benefit obligation to an insurance company. Employers questioned whether they could offer lump sums rather than buying annuities for retirees whose benefits are already in pay status.

Before these rulings, the 2004 IRS minimum distribution regulations for defined benefit plans appeared to bar the offer of a lump sum cash-out to retired participants receiving benefit payments, except in the case of plan termination and certain other narrow circumstances.

On an informal basis, some practitioners asked the IRS why minimum distribution rules that were aimed at limiting tax deferral would stop a plan from *accelerating* the payment (and taxation) of annuity benefits. And when asked whether the guidance found in question 14 of those regulations (which describes increases in annuity payments as a reason for accelerating payments) might offer relief, the IRS held back from providing confirmation.

Private Letter Ruling Settles Issue for Select Employers

With the usual caveat that a Private Letter Ruling is directed only to the taxpayer who requested it and cannot be used or cited as precedent, the IRS now confirms in Private Letter Rulings 201228045 and 201228051 that a lump sum offer to cash out a benefit in pay status during a limited window period is permitted when made in connection with an amendment to the plan. In reaching this conclusion, the IRS looked to question 14 in the minimum distribution regulations, which asks, "Are annuity payments permitted to increase?"

Among the list of reasons cited in question 14 as permitting an increase is "to pay increased benefits that result from a plan amendment." The employers that requested these letter rulings proposed to amend their plans to add the lump sum option, thereby changing the annuity payment period and "increasing benefits." The IRS ruled that "because the ability to select a lump sum option will only be available during a limited window, the increased benefit payments will result from the proposed plan amendment and, as such, are a permitted benefit increase." The fact that some participants may choose to stretch out payments for a longer period by choosing a joint and survivor form of payment in lieu of a current life annuity apparently does not disturb this result. It is also unclear in what way the existence of "a limited window" bears on the conclusion that the increased benefit payments result from the proposed plan amendment.

Now that we know it may not disqualify the plan, how is it done?

Both letter rulings focus primarily on the ability to change the form of payment. (One of the rulings also considered whether the plan can continue to use a plan-specific mortality table for funding purposes, and whether the 50% excise tax on minimum distribution failures would be applicable to payees on amounts in excess of the current-year minimum required distribution as a result of implementing the lump sum window.) But aside from footnotes and cross-references, neither ruling asks for confirmation of details on execution. Key plan compliance considerations for retiree window offers include spousal consent, optional forms, maximum benefit limitations, minimum present value requirements, funding-based prohibited payment restrictions, nondiscrimination rules, nonduplication of benefits, and eligible rollover distribution requirements.

Spousal consent. For a participant who was married at the time payments started (the original annuity starting date), the original form of payment elected was either a form of payment that met the qualified joint and survivor annuity requirements - in which case spousal consent wasn't necessary - or another form of payment that was chosen with the consent of the spouse on the original annuity starting date. To change the selection made initially, the retiree generally must obtain the consent of the spouse at the original annuity starting date (if that spouse is still living), even if the participant has since been divorced from this spouse.

In addition, there would be a new annuity starting date when payments commence under a new option, so that if the participant chooses an option other than a form of payment that meets the requirements for a qualified joint and survivor annuity, the consent of the participant's current spouse, if any, on the new annuity starting date would be required. Because both a former spouse and the current spouse

may need to consent when a divorced participant has remarried, election forms for the lump sum window may require more than one spousal consent section.

Optional forms. The lump sum offer establishes a new annuity starting date. At a minimum, this means that in addition to the lump sum, the plan's qualified joint and survivor annuity (QJSA) must be offered to all participants and the qualified optional survivor annuity (QOSA) options must be offered to married participants. The options that must be offered depend on the retiree's marital status on the new annuity starting date.

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Although the letter rulings do not specifically address the point, it should be noted that the plan cannot automatically cash out retirees whose remaining vested benefits have a present value of $5,000 or less. Plans are permitted to distribute lump sums without obtaining advance participant consent if the present value is $5,000 or less, but this small-payment cash-out rule is only available at the time distributions commence. Plans are not permitted to cash out retirees without their consent merely because their benefit's value drops below the threshold as they age and have an expectation of fewer remaining payments under their life annuity. Plans can extend the lump sum offer to these retirees under the window offer, but a QJSA and QOSA must be offered in addition to the lump sum.

Maximum benefit limitations. Under Treasury regulations explaining the application of the Code Section 415 maximum benefit rules where distributions start at more than one annuity starting date, plans must show that the limitations of Section 415 will be satisfied as of *each* annuity starting date, taking into account the benefits that were provided at *all* of the annuity starting dates. The rule in the minimum distribution regulations specifies that the 415 limit must be met at both dates and specifically requires satisfaction of the maximum benefit limitation, taking into account the entire payment stream using the interest and mortality tables in effect on the *original* annuity starting date. Although not emphasized in the regulations, the regulatory preamble does mention considering all payments at the second date, so the two regulations appear to be consistent. The IRS and the Treasury Department state in their preamble to the final Section 415 regulations that they are developing new proposed regulations on multiple annuity starting dates, and corresponding revisions to the minimum required distribution regulation, but these have not yet been published.

The Section 415 Treasury regulations also make clear that spousal survivor benefits are only ignored in testing the limits if the participant's benefit is paid in a QJSA form. Therefore, if a participant is receiving benefits in a QJSA form at the Section 415 maximum level, for example, the plan cannot include the survivor benefit in offering a lump sum cash-out of the value of the remaining payments under the QJSA annuity. Nor can the plan offer a lump sum based on the remaining lifetime payments to a surviving spouse of a deceased participant who had been receiving the maximum.

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Typically few participants are affected by these limits. Until the minimum distribution and Section 415 regulations are revised to explain how to apply them in the case of multiple annuity starting dates, plan administrators should be prepared to demonstrate a reasonable and good faith approach to compliance that takes into account the entire stream of payments measured as of each annuity starting date.

Minimum present value requirements. Guidance is also sparse on determining the minimum present value (also known as minimum lump sum) under Code Section 417(e) where there are multiple annuity starting dates.

The aforementioned minimum required distribution regulations specify that, when the form of payment is modified, the date of modification is treated as a new annuity starting date. Thus, the lump sum offer must satisfy the minimum present value requirements using the interest rates and mortality tables in effect on the *new* annuity starting date. The regulation does not require taking into account the interest and mortality tables in effect on the *original* annuity starting date.

Because the Section 417 requirement constrains the interest and mortality basis and requires the lump sum to reflect the value of the accrued benefit at normal retirement as a minimum, the payment modification rule in the minimum required distribution regulation seems to fall short because it doesn't address taking into account the potentially higher value of the annuity at normal retirement age. Presumably it should include that value, but be adjusted to reflect prior payments and death benefit coverage that would have expired during the intervening period due to the death of a joint annuitant or the depletion of any period certain guarantee.

To illustrate, consider a retiree who starts annuity benefits at age 55. Had the plan offered a lump sum at the original annuity starting date based on the greater of the present value of the immediate benefit ($400,000) or the present value of the deferred benefit ($500,000), the offer would have been $500,000. After making a single annuity payment of $2,500, could the plan be amended to now offer a lump sum at a new annuity starting date and pay just the remaining value of the immediate annuity (about $400,000 minus $2,500)? Or must the offer be closer to $497,500? Some IRS actuaries informally indicated that the window offer would have to reflect the higher value.

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Two key points: Although the obligation to provide a minimum lump sum based on the normal retirement accrued benefit might seem to be in conflict with the requirement in the minimum distribution regulations that the actuarial present value of the remaining payments be the entire interest of the participant under the revised payment form, the payment in the retiree window case is being made

under the alternate rule that allows for a change where there is an *increase* due to a plan amendment. Second, to avoid an impermissible forfeiture where the lump sum required to be paid due to Section 417(e) exceeds the amount permitted to be paid under the Section 415 maximum benefit rule, the plan may have to exclude an affected retiree from the window option.

Funding-based prohibited payment restrictions. Under the Code Section 436 restrictions, certain plans are prohibited from paying distribution options that deplete plan assets faster than life annuity options. Restricted options include lump sums, period certain annuities, and Social Security level income options. Section 436 limits any payment of these options if the plan's adjusted funding level is below 60% or if the plan's adjusted funding level is below 100% and the plan sponsor is a debtor in bankruptcy (or involved in a similar type of proceeding under federal or applicable state law). However, up to one-half of a participant's benefit can generally be paid in one of these forms if the plan sponsor is not in bankruptcy and the plan's adjusted funding level is below 80% but at least 60%. The partial payment is limited to the value of the PBGC maximum benefit guarantee under a plan termination.

Under the Section 436 restrictions, plans are also required to apply a funding-based test to determine whether an amendment can go into effect if it increases plan liabilities. Under IRS regulations, values are currently determined on the basis of the present value of the associated annuity using funding interest rates. This value is reduced when using stabilized interest rates under the Moving Ahead for Progress in the 21st Century Act (MAP-21). (See our July 6, 2012 *For Your Information*.) It is possible that future guidance from the IRS and the Treasury will require a closer evaluation of the cost of offering lump sums, particularly in the case of a window opportunity that settles a large liability in a short period of time at interest rates that are significantly different from those used for funding.

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Plan sponsors considering offering lump sums need to be mindful of the plan's current funding level and consider how it will change based on the take-up rate. (Generally, paying a lump sum decreases the plan's funding ratio.) The sponsor may want to limit the population offered the window if this is a concern. Plan sponsors should also watch for changes in requirements for testing plan amendments and be aware of the actual cost associated with the offer of lump sums.

Nondiscrimination. Adding a lump sum feature to a plan for a select group of employees or former employees (such as retirees) must be evaluated for nondiscrimination in terms of the amount of benefit provided, the availability of plan benefits, rights, and features, and the timing of the amendment. For example, making a limited window offer when certain key highly compensated employees (HCEs) decide to retire would be problematic; extending such an offer only to non-HCEs would be fine.

Plan sponsors also need to watch out for the nondiscrimination funding-based limit on distributions to HCEs, commonly referred to as the “high-25” rule. A lump sum distribution to one of the plan sponsor’s 25 highest-paid HCEs is permitted only if either the value does not exceed 1% of plan liabilities or the assets of the plan after the distribution are at least 110% of plan liabilities.

Nonduplication of benefits. Although most plans routinely include a nonduplication-of-benefits clause that addresses adjustments to future distributions for individuals who return to service and accrue additional benefits, if such a provision is not included or is unclear, plan sponsors should consider including or modifying nonduplication language with the amendment implementing the lump sum window. Plan provisions calling for the suspension of benefits in pay status on a return to employment may also need attention. Retirees may have an increased interest in returning to work once they “lock up” a lump sum payment and are able to avoid a temporary or permanent suspension, so these details may become particularly important for future administration.

Eligible rollover distributions. Under the rollover rules, individuals cannot roll over the amount that has to be distributed for the year under the minimum distribution requirement and plan administrators must offer the rollover option for amounts eligible for rollover. Therefore, in administering the new lump sums, the plan administrator will have to determine and communicate the relevant amounts (including an assessment of the remaining tax basis attributable to after-tax employee contributions, if any). Procedures for default rollovers and income tax withholding and reporting must be addressed.

Whether the 50% excise tax for failure to receive a minimum distribution would apply to payees on amounts in excess of the current year minimum required distribution as a result of implementing the lump sum window was addressed in one of the two cited private letter rulings. According to the ruling, as long as the plan limits the amount rolled over to the amount in excess of the minimum required distribution and distributes the required minimum to the retiree, implementing the window lump sum offer will not trigger the 50% excise tax.

Individual Tax Issue

In addition to the plan-level concerns mentioned above, plan sponsors should be aware of the tax penalties that some retirees accepting lump sum cash-outs could encounter. Those who started receiving annuity benefits before age 59½ and separated from service before age 55 could face retroactive application of the Code Section 72(t) 10% additional tax on premature distributions for all years in which annuity payments were received. Those relying on the exception for payments made in substantially equal periodic payments over their life or life expectancy (or over the joint lives or joint life expectancies of the employee and beneficiary) are subject to the penalty if there is a change in payments before age 59½, or after age 59½ if the change is made before they receive payments for at least five years, unless the change relates to death or disability. An acceleration of annuity payments for other reasons would not appear to qualify for the exception to the tax, nor would a rollover in the current year prevent the penalty’s retroactive application to prior tax years.

In Closing

Sponsors of plans that are sufficiently funded to consider offering lump sum distributions should consider obtaining their own tax ruling on the key issue addressed by the recently released private letter rulings, as well as on the other concerns highlighted above. An additional factor is the reaction of retirees. Although it is uncommon to hear complaints from participants who are offered lump sums as a routine matter under their plan, recent press reports about the offers to GM and Ford employees are replete with participant complaints about the difficulty of the decision and the expectation of some problems down the road. Employers will want to evaluate the anticipated reaction of their own retired population, and the potentially negative publicity in the years ahead if retirees mismanage and 'outlive' their lump sum payment.

Buck Can Help

- Estimate the effect of a lump sum window or annuity purchase transaction on plan liabilities
- Identify suitable approaches for valuing lump sum offers
- Evaluate funding and nondiscrimination barriers
- Identify issues that may warrant a private letter ruling request to the IRS
- Conduct retiree focus groups to obtain feedback on potential concerns and information needs
- Prepare suitable retiree communication materials
- Assist with the task of cleaning up participant data in anticipation of a lump sum offer

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.
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