

## IRS Clarifies Minimum Present Value Rules for Partial Annuity Distributions

The IRS has issued final regulations on applying the ERISA minimum present value requirements to participant distributions involving combinations of annuities and accelerated distributions (such as lump sum cashouts). The regulations generally support the approaches most plans had been using in the absence of official guidance. The regulations are available retroactively and offer limited anti-cutback relief for plans that are timely amended to support their desired calculation approach for future distributions.

### Background

In 1988, IRS issued final regulations that explained how to apply the Retirement Equity Act's minimum present value requirements for ERISA-covered defined benefit plans that offer non-annuity distributions. The regulations focused on plain vanilla situations that assumed a participant's entire benefit would be paid in a single form beginning at a single annuity starting date. Although the regulation did say that "the amount of a distribution" paid in the form of an annuity that did not decrease during the life of the participant would not be required to apply the IRC Section 417(e) applicable interest rate and applicable mortality table, IRS representatives typically asserted that once any portion of a benefit was subject to using the rates, the entire benefit would be required to be determined using 417(e) rules — including the minimum based on the value of the normal retirement benefit. This led to inconsistent results when a plan allowed just a portion of a benefit to be paid in a non-annuity form because the remainder would be determined using the 417(e) factors rather than the plan's optional form factors that were used when the entire benefit was paid in annuity form and the implicit early retirement adjustment in the 417(e) calculation would compete with the plan's early retirement factors.



It is not uncommon to find situations where portions of a plan benefit are subject to separate distribution options and factors. Plan amendments may eliminate certain benefit options and factors but generally, plans must grandfather them to avoid violating the anti-cutback rule, often in connection with plan mergers. Some plans call for mandatory employee contributions and allow participants to cash out the benefit attributable to employee

contributions, but not the employer-provided benefit, at retirement. And with the advent of PPA, plans are sometimes required to bifurcate benefits due to the funding-based distribution restrictions (which may partially restrict non-annuity distributions); others face bifurcation because of the plan sponsor's adoption of a cash balance or other hybrid design that includes a lump sum option as a replacement for a traditional formula that did not include a lump sum option.

In 2012, IRS proposed regulations for handling these bifurcated benefit situations. In part, the effort was aimed at facilitating better participant decisions to opt for partial annuities rather than fully cashing out benefits. It was accompanied by guidance on offering lifetime income options from defined contribution plans and other clarifications as we explained in our [February 27, 2012 For Your Information](#).

IRS planned to accommodate the 2012 proposed changes on a prospective basis, but many who responded to their request for comments pointed out that plan documents and procedures often had taken the more pragmatic and logical approach of limiting the use of the 417(e) rules to just the portion of a participant's benefit paid in forms that did not meet the regulatory exceptions.

## Final Regulations Offer Balanced Approach

The [IRS regulations](#) modifying the minimum present value requirements for partial annuity distribution options under defined benefit pension plans offer two rules for addressing these situations. The rules are effective for distributions with annuity starting dates in plan years beginning on or after January 1, 2017, but may be applied retroactively. Which rule to use mostly turns on how the plan defines the availability of benefit options.

### Rule 1: Explicit Bifurcation of Accrued Benefit

The first rule, likely to be applied in most situations, is used when the plan document identifies a specific portion of a participant's *accrued benefit* that is settled when paid in a form subject to the minimum present value requirements. This could be a percentage of the accrued benefit, or a design-based portion, such as the cash balance portion of an accrued benefit, the employee-provided accrued benefit, or the portion of the accrued benefit transferred from another plan. As long as the identification focuses on the accrued benefit, options and factors can attach to the separately identified portions.

### Rule 2: Implicit Bifurcation of Accrued Benefit

The second rule is for plan provisions that do not focus on the accrued benefit to establish the participant's choices. For example, a plan provision that allows up to a set dollar amount, such as \$10,000, to be paid in a single sum would fall in this category. Another example would be a plan provision that states that the participant can choose a lump sum equal to the value of their employee contributions plus interest.

**Comment.** Words matter. Whether the rules for explicit versus implicit bifurcation apply to the benefit under the plan will turn on how the split is described in the plan document. For example, offering a lump sum of the accumulated contributions with interest comes under the implicit bifurcation rules, but an offer to cash out the employee-provided accrued benefit comes under the explicit rules even though the dollar amount of distribution may be the same.

Under the implicit bifurcation rule, the portion of the remaining accrued benefit payable in annuity form cannot be less than the participant's total accrued benefit expressed in that annuity form less the actuarial equivalent value of the lump sum expressed in that form determined using Section 417(e) factors.

**Comment.** The final regulation limits implicit bifurcation to single-sum payments. Sponsors who used the implicit bifurcation approach described above for other Section 417(e) forms of payment (such as installment payments without a life contingency) must fashion an approach that changes to the explicit bifurcation approach for these distributions with annuity starting dates on or after the first day of the plan year beginning on or after January 1, 2017.

## Operating Rules

A handful of rules explain how the minimum present value rule is applied when the benefit is bifurcated and state some limitations.

**Situations that must be explicit.** Certain situations are barred from using the implicit rule. The first concerns plan amendments that eliminate an optional form of benefit. The plan must explicitly split the accrued benefit based on the grandfathered portion of the benefit versus the remaining accrued benefit. The second is where the entire benefit is available in a single-sum distribution, but the plan offers the option of settling just a portion with a single-sum payment.

**Example.** A plan that provides a single-sum distribution based on a subsidized early retirement benefit is amended to eliminate that form of payment. The plan may not use the subsidy from the implicit bifurcation calculation to eliminate any portion of benefits that accrue after the date of the amendment.

**Benefits and factors that apply to only a part of the accrued benefit.** Plans must specify which portion of a benefit is settled by a distribution if the plan offers partial settlements and provides different early retirement factors, retirement-type subsidies, optional forms of benefit, or ancillary benefits that apply only to a portion of the participant's accrued benefit.

**Same annuity starting date.** Bifurcated benefits are treated separately even if both benefits have the same annuity starting date. One benefit may be subject to the minimum present value rule while the other is not.

**Slice and dice.** Bifurcated benefits can be bifurcated again. For example, plan benefits may be bifurcated into the portion of the benefit arising from a cash balance formula versus a traditional formula. The benefits under the traditional formula may be further bifurcated due to a plan amendment eliminating a lump sum option for benefits that accrue after a certain date, resulting in a traditional piece that can be paid in a single sum and a second traditional piece that can only be paid in annuity form.

## Anti-Cutback Relief

For many plans, these final regulations will be viewed as validation of what they had logically been doing all along. But for some — those that incorporated language to apply the view that any portion paid in non-annuity form would subject the entire benefit to the 417(e) minimum present value requirement — the final regulation allows limited relief from the anti-cutback rule to allow them to calculate benefits going forward using a bifurcation rule without having to continue applying the minimum present value requirement to the entire benefit. This relief is available for amendments adopted by December 31, 2017.

## Social Security Level Income Options

The final regulation does not explain what this might mean for Social Security level income options. Some practitioners and plan sponsors do not read the minimum present value requirements to apply to these forms of payment. The guidance sheds no new light on this issue and does not explicitly say whether a benefit might be bifurcated to apply the minimum present value rule. For example, these options essentially offer the participant the ability to take a portion of the accrued benefit as a temporary annuity (equal to the estimated amount of the Social Security benefit and payable until Social Security benefits commence), with the remainder of the accrued benefit (if any) payable as a life annuity. Under the final regulations, if the plan document defined the benefit in terms of splitting the accrued benefit into these two parts, only the temporary annuity portion of the payment would be subject to 417(e) factors, and any remaining life annuity benefit options would not be required to be determined using 417(e) factors. Additional 417 proposals are on the IRS [priority guidance plan](#) that will likely confirm this treatment.

## In Closing

One stated objective for finalizing this regulation is to allow plans to simplify the treatment of partial payments because participants are better served by having the option to receive a portion of the benefit in annuity form rather than having to make an all-or-nothing decision. It remains to be seen whether plan sponsors will add partial distribution options as a feature rather than merely using the guidance to manage variations that have emerged because of plan mergers and design changes.

Sponsors of defined benefit plans that offer partial lump sums (or partial distributions in other forms of payment subject to Section 417(e)) will need to take stock of their plan provisions and plan operations, and determine whether changes are necessary to comply. In addition, plans that offer early retirement benefits, retirement-type subsidies, optional forms or ancillary benefits on only a portion of the accrued benefit may need to incorporate provisions that describe how the plan will determine the applicability of those provisions to the remaining benefit. If sponsors wish to take advantage of the limited anti-cutback relief, plan amendments must be adopted no later than December 31, 2017.

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