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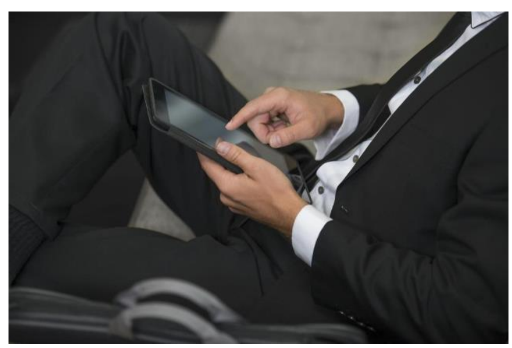
IRS Proposes More Changes to Minimum Present Value Calculations

Proposed regulatory changes from IRS would update the rules for calculating the minimum value for certain defined benefit plan distributions — primarily lump sums from plans that are not eligible for the cash balance (hybrid plan) exception. The changes incorporate PPA segment rates and the PPA mortality tables, establish a standard for reflecting preretirement mortality, and provide an example of how the rules apply in calculating Social Security level income options.

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. Over the years, plan sponsors and practitioners have asked many questions about how to apply the regulations to certain fact patterns. Earlier this year, IRS finalized changes to these regulations to address questions about how the minimum present value rule would be applied to participant distributions involving combinations of annuities and accelerated distributions (such as lump sum cashouts). Our September 14, 2016 *For Your Information* discusses those changes.



September's final regulation did not address long-standing questions about Social Security level income (SSLI) options and whether the minimum present value requirements apply to these forms of payment. Would the option be treated as a bifurcated benefit, with a portion of the accrued benefit taken as a temporary annuity evaluated using IRC 417(e) interest and mortality and the remainder as a life annuity determined using plan conversion factors? Or perhaps IRS has come around to the view that a SSLI option is just another annuity not subject to the minimum present value rules?

Other outstanding questions involved the use of preretirement mortality in the calculation of minimum lump sums (and minimum present values of other forms subject to these requirements). Indeed, some of these questions were the subject of court disputes centering on whether a plan could discount the value of an accrued benefit payable at a date in the future by imposing a mortality discount without regard to any preretirement death benefits that might be payable. For example, the 6th and 7th Circuit Appeals Courts concluded that the preretirement mortality discount was ***not*** permitted for a cash balance plan's "whipsaw" calculation because the cash balance was not forfeited if a participant died. Although — thanks to the Pension Protection Act of 2006 (PPA) — cash balance plans are generally no longer subject to the whipsaw calculation, the question of whether to apply preretirement mortality remains relevant for many defined benefit plans.

Proposed Regulation Would Expand Guidance and Clean House

IRS issued proposed regulations to update the minimum present value requirements to reflect the PPA interest rates and mortality tables as well as the exception for hybrid plans. The proposal would also clarify when, and when not, to reflect preretirement mortality. Finally, it would set forth their position on applying the minimum present value rules to SSLI options.

Social Security Level Income Options

In keeping with IRS' long-standing position that a SSLI option is different from a Social Security Supplement (which enjoys an exception from the minimum present value rules), the proposed regulation would formalize IRS' view that the minimum present value rules apply to these options. Accordingly, the present value of the SSLI option cannot be smaller than the present value of the individual's accrued benefit at normal retirement date using IRC 417(e) interest and mortality — just like the minimum for a lump sum option. The proposed regulation does not offer the option of using bifurcation so that the net annuity options are proportional to the annuities without the SSLI feature.

Although many plans have been written to determine SSLI options based on the better of the plan option rates or IRC 417(e) factors in keeping with the informal confirmations provided over the years in various forms, some perform this comparison based on the early retirement benefit rather than the normal retirement benefit. Depending on how the plan's early retirement factors compare to the implicit early retirement adjustment of the IRC 417(e) rates, this approach may not satisfy the IRC 417(e) minimum present value requirements.

> **Hybrid Plan Alert**: If your cash balance or other hybrid plan satisfies the requirements for whipsaw relief, then the IRC 417(e) rates generally do not apply. That's true for lump sums and it can be true for SSLI options as well if the SSLI option is actuarially equivalent to the cash balance using reasonable rates; the IRC 417(e) rate is not required.

Preretirement Mortality

The proposed update to the IRC 417(e) regulation would clarify when — and when not — to use a preretirement mortality discount in determining minimum present value. The proposed IRS regulation would not adopt the position of the courts in the cash balance cases! In short, the proposal would allow the preretirement mortality discount to apply for employer-provided benefits, but not for benefits from employee contributions. IRS makes this distinction because employee-provided benefits cannot be forfeited on death under IRC 411 — but employer-provided benefits may be (except for the qualified preretirement survivor annuity, or "QPSA").

> **Comment:** Although IRS acknowledges in the preamble to these proposed regulations that the QPSA cannot be forfeited, they do not explain why it can be ignored for the employer-provided benefit value.

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Post-Normal Retirement Date Adjustments

The minimum present value of the normal retirement benefit using the mandated interest and mortality rates applies after normal retirement date as well as before. Thus, applying the proposed rule for preretirement mortality, the effective result is a minimum actuarial increase for any payment form subject to the minimum present value requirement based on both interest and mortality for employer-provided benefits and "interest-only" for employee-provided benefits. Fortunately, this has generally not been an issue for most plans because plan rates for post-normal retirement actuarial adjustments produce greater increases than would IRC 417(e) and, for ongoing plans, the required minimum can also be satisfied by additional accruals.

IRS' proposed revision would clarify that the post-normal retirement minimum increase does not apply "to the extent" the plan meets the suspension of benefits requirements. For the minimum, a valid suspension of benefits provision will allow the plan to determine a post-normal retirement lump sum (or other IRC 417(e) option) as the present value of the benefit at the delayed start date rather than the benefit at normal retirement date.

> **Comment:** Plans that "suspend" benefits call for the forfeiture of the benefit during periods of continued or return employment. As a result, many plans that suspend benefits do not even offer lump sums, as a lump sum effectively precludes the possibility that benefits might later become forfeited. Therefore, on a practical level, the new information in the proposed rule is perhaps more important for the message it conveys that IRS sees a connection between the nonforfeiture rules of IRC 411 and whether or not preretirement mortality should be reflected in actuarial increases post-normal retirement in general.

PPA Segment Rates

The proposed revisions to the regulation would clean up references to various interest and mortality bases that have applied over the years due to legislative changes. Specifically for PPA, the cleanup adds the relevant segment rates.

Effective Date, Request for Comments, Anticutback

The final rules dealing with PPA and other changes, such as the preretirement mortality issue, will be effective for distributions with annuity starting dates in plan years beginning on or after the date they are published in the *Federal Register*. No specific date is mentioned for the new SSLI example.

IRS asks for comments on the proposed changes by February 23, 2017. In addition, IRS asks for comments on whether or not the regulation should require a plan that provides lump sums equal to the present value of a subsidized early retirement annuity to determine minimum present values for IRC 417(e) forms of payment using the actuarial equivalent of the early retirement annuity, or whether the minimum based on the normal retirement benefit is sufficient to meet the protection required by IRC 417.

The proposal includes anticutback relief for plan changes due to PPA interest and mortality but does not include relief for any changes that might be made to reflect the clarifications to the preretirement mortality rules or the SSLI determination. Plans that currently do not use the preretirement mortality discount would need such relief to add it to their plans. Furthermore, such a plan may find itself outside of the "most valuable QJSA" exception, as it will be paying a higher value than the minimum using the preretirement mortality discount.

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In Closing

Sponsors of plans that use protocols for determining lump sums, SSLI or other distribution options subject to the minimum present value rule that are different from than those clarified in the proposed regulations will want to evaluate whether the proposed regulations will require a change to benefit distributions and plan provisions and whether to make changes in advance of the final rule.

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