

## IRS Model Amendments Help Defined Benefit Plans Address Bifurcated Benefit Options

IRS has just issued model amendments to assist defined benefit plan sponsors that allow participants to split their pension among forms of distribution options, typically, paying part of the benefit in annuity form and part in a lump sum. Sponsors of plans that already offer this “bifurcation” may need to adopt amendments to their plans for 2017 to comply with the 2016 final regulations, and these model amendments may be helpful. Those who want to add partial annuitization going forward can also use the models.

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### Background

In 2016, the IRS issued final regulations on applying the ERISA minimum present value requirements of IRC Section 417(e) to participant distributions involving combinations of annuities and accelerated distributions (such as lump sums, fixed installments without a life contingency, and social security level income options). The regulations generally support the approaches most plans had been using in the absence of official guidance. In part, IRS’ effort was aimed at encouraging plan sponsors to offer partial annuities rather than making participants choose between an annuity and fully cashing out their benefits. See our [September 14, 2016 For Your Information](#) for details on how the minimum present value rules operate and on limitations IRS set on the calculation approaches – explicit or implicit – for bifurcating benefits.

Throughout this *For Your Information* we will generally refer to “lump sums” to mean the array of accelerated distributions that are subject to the IRC 417(e) minimum present value rules.

### Partial Lump Sums Currently in Plan Documents

Many, if not most, defined benefit plans currently include provisions that contemplate the possibility of partial lump sum distributions. Some

#### A word about cash balance and other hybrid plans

Assuming the plan has opted to eliminate whipsaw by meeting PPA requirements – that plan or portion of a plan is not subject to the 417(e) minimum present value rule. So if the plan only pays a lump sum of the cash balance, or only allows the cash balance to be used for the temporary annuity portion of a Social Security Level Income option, then the plan need not apply the 417(e) rule. If the plan provides such options on traditional benefits provided under the plan (e.g., an A + B arrangement) then the 417(e) rule only applies to that traditional portion of the plan.

plans include partial lump sums as remnants of benefit distribution options that ceased to be available for benefits accrued after a certain date, as often occurs when a lump sum option must be preserved in connection with a plan merger. If for no other reason, ERISA covered single-employer plans must impose limitations on lump sums when the plan's funding level falls below 80% but is at least 60% to comply with the funding based benefit restrictions in IRC Section 436, resulting in a bifurcated benefit.

Current plan language on how to determine the portion of the benefit available in a lump sum and how to determine any remainder may or may not be acceptable under the 2016 regulation. If it is not, a remedial amendment is required to be adopted with an effective date of no later than the start of the 2017 plan year. For example, plans that offer subsidized early retirement factors or optional forms of benefit that only apply to part of the accrued benefit must be amended to specify whether those features will apply to the remainder if the plan document does not already address those issues.

If the plan includes provisions for which anti-cutback relief is available [i.e., it provides that 417(e) applies to the entire benefit if any portion is paid in a form subject to 417(e)], the amendment to take advantage of that relief will need to be adopted by December 31, 2017.

If the plan sponsor is not taking advantage of the anti-cutback relief, the amendment deadline varies based on whether the plan is individually designed or if the plan is pre-approved (formerly known as Master/Prototype or Volume Submitter documents). If the plan is individually designed, the amendment must be adopted by the end of the second calendar year that begins after the year in which the issue appears on the IRS required amendments list. The required amendments list for 2017 has not been issued yet, but if these amendments are listed on it (as we expect), the deadline for adopting the amendment for an individually designed plan would be December 31, 2019. The deadline for amending a pre-approved plan would generally be the later of the end of the 2017 plan year, or the due date (including extensions) for filing the employer's income tax return for the taxable year that includes January 1, 2017.

Amendments should also be considered where plan language is less than clear about how calculations are to be done – to remove all doubt and avoid having to dig into regulations to interpret a plan provision. For example, IRS model amendments in [Notice 2011-96](#) to address the requirements in IRC 436 merely provide that the plan will be interpreted and administered in accordance with the Section 436 regulations. Those regulations state that IRC 417(e) applies separately to the restricted and unrestricted portions of the benefit, but the reader is forced to comb through regulations to know that.

## **Adding New Partial Lump Sums to a Plan**

As noted above, IRS' objective in amending the regulation was, in part, aimed at facilitating better participant decisions in selecting distribution options. Offering bifurcated options would allow participants to opt for partial annuities that provide basic financial protection against unexpected longevity with a partial lump sum that can be used to provide increased liquidity during retirement.

**Comment.** Plan sponsor appetites for making such a change may depend on whether the plan currently offers lump sums at all. In addition to philosophical opinions about the role of the plan in supporting participant financial needs in retirement, many plan sponsors will consider how offering bifurcated options will affect plan liabilities and costs such as ongoing PBGC premiums. With sponsors looking at the

derisking option of offering full lump sums to reduce headcount for premium purposes, there is a disincentive to bifurcate the benefit, particularly in the case of relatively small amounts. This disincentive is more significant for underfunded plans that are paying variable rate premiums to the PBGC, which are currently capped at \$517 per participant.

An amendment to add a new partial lump sum option to the plan is a “discretionary” amendment. Plans are allowed to start operating under the change during the year as long as an actual amendment is adopted by the end of the plan year.

## IRS Model Amendments

In [Notice 2017-44](#), the IRS provides model amendments to allow for bifurcated optional forms of benefit under either the explicit or implicit methods described in their IRC 417(e) present value regulation. The explicit method that describes the bifurcated portions based on the individual's accrued benefit at normal retirement may be used for all situations. The implicit method that calculates the affected accrued benefit by applying the 417(e) rates to the single sum paid currently, is not permitted to be used for optional forms other than single sums, for certain grandfathered options, or where the full benefit is offered as a single sum.

The notice makes clear that plans with bifurcated distribution options do not need to use this specific model language as long as the plan language otherwise complies with the IRC 417(e) final regulations.

Both amendments in the notice allow the plan sponsor latitude to define the relevant portions of the benefit that may be selected in different forms. Examples provided by IRS include:

- A participant who elects to bifurcate his or her accrued benefit may divide the benefit between no more than two distribution forms.
- Bifurcation may be available only for specified percentage divisions of the accrued benefit that are set forth in the plan. For example, a plan could provide that the only permitted bifurcations are a 50/50 or a 75/25 division.
- Bifurcation may be available only between the portion of an accrued benefit earned before a specified date and the portion of an accrued benefit earned on and after that date.
- A participant may elect to bifurcate his or her accrued benefit only into a lump sum distribution and an annuity (and the amount permitted to be paid as a lump sum may be capped at a specified dollar amount or a specified percentage of the participant's accrued benefit).

**Comment.** The model amendments do not contain the provisions a plan sponsor may need to adopt if the plan offers an early retirement benefit, retirement-type subsidy, optional form of benefit or ancillary benefit that applies only to a portion of the accrued benefit. The plan sponsor may need to add their own language to meet the requirement that the plan specify how those benefits (or subsidies) will be available on the remainder of the benefit after the lump sum is paid.

Plan sponsors will want to also consider limiting the remainder available in annuity form to avoid retaining small amounts that cannot be cashed out under the plan's small payment rule. For example, the sponsor may wish to bar bifurcation if the present value of the remainder annuity is less than \$10,000.

## In Closing

The IRS model amendments may be useful in adding bifurcated benefit language to plans for new provisions and to address IRC 436, but may not be adequate for more complicated situations involving grandfathered benefits and actuarial factors. In any event, the IRS notice does serve as a useful reminder that time is growing short to make sure plan language is clear whenever participants are offered different payment forms for distinct portions of their benefit. The new guidance does not squarely address Social Security Level Income options – another form of payment that is subject to IRC 417(e) and arguably affected by the bifurcation regulations. More regulations are in store for these options as proposed by IRS at the end of 2016 (see our [December 1, 2016 For Your Information](#)).

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