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IRS updates final rules on minimum present value calculations for defined benefit plans

The changes, which must be applied to annuity starting dates in October 2024 or later, finalize PPA changes to the interest rates and mortality tables used to value lump sums and certain other accelerated distributions, and address the treatment of preretirement mortality discounts and social security level income (SSLI) 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.

These rules are used to determine the minimum amount that the plan can pay as an accelerated distribution (such as a lump sum) to settle the accrued benefit (or a portion thereof). They are also used to determine whether the entire accrued benefit can be cashed out as a lump sum without obtaining the participant's consent (or the spouse's consent, if married) because the present value of the accrued benefit does not exceed the mandatory cash-out limit set forth in the plan (which cannot exceed $7,000 for annuity starting dates on January 1, 2024 or later).

The Pension Protection Act of 2006 (PPA), in connection with its changes to the minimum funding rules, changed the applicable mortality tables and interest rates required to be used to calculate the minimum present value for accelerated distributions. PPA also allowed "applicable defined benefit plans" that define the accrued benefit based on a hypothetical account balance (under a cash balance plan) or an accumulated percentage of final average pay (under a pension equity plan) to determine lump sums and other accelerated forms of payment without regard to these rules.

In 2016, IRS issued updates to the final rules to address how the minimum present value rules could be applied to only a portion of the benefit for plans that pay an accelerated distribution on part of the accrued benefit (and pay an annuity on the other part). (See our September 14, 2016 *FYI* on the final regulations). In 2016, IRS also issued proposed regulations that addressed preretirement mortality discounts and social security level income options — soliciting public comments on them. IRS also solicited public comments on whether plans that provide early retirement lump sums should be required to use the applicable interest rate and mortality table in the calculation of minimum lump sums when there are early retirement subsidies incorporated in the immediate annuity and the plan provides that the lump sum at early retirement will be no less than the present value of that immediate annuity. (See our December 1, 2016 *FYI* on the proposed regulations.)

Final regulations mostly follow the proposed regulations

The final rules address the topics covered by the 2016 proposed regulations similarly, but also provide some additional anti-cutback relief.

Note that these changes to the minimum present value rules do not apply to governmental or nonelecting church plans that are not subject to ERISA minimum vesting standards (unless the terms of the plan expressly incorporate such requirements even though they are not required to).

Updates for PPA and other law changes

The new rules reflect the three segment interest rates used for funding under PPA (but without 24-month averaging, and without the segment rate stabilization provisions subsequently enacted) and the mortality tables that were established under PPA. They also incorporate the special rules for applicable defined benefit plans with lump sum-based benefit formulas.

Preretirement mortality

Consistent with the proposed regulations, the final rules allow a preretirement mortality discount to be applied when determining the present value of the accrued benefit derived from *employer* contributions — even if the plan pays a death benefit equal to the accrued benefit when a participant dies before commencing benefits prior to attaining normal retirement age. The final rules reiterate that preretirement death benefits are ancillary benefits (that are not protected from being eliminated prospectively) and are not part of the accrued benefit subject to the minimum present value requirements unless they are part of the normal form of benefit.

Also consistent with the proposed rules, the final rules prohibit applying a preretirement mortality discount for the period before normal retirement age when determining the present value of the accrued benefit derived from *employee* contributions (which cannot be forfeited even if the participant dies before normal retirement age). The preamble states that this rule does not have to be applied retroactively, and that, if a plan applied a preretirement mortality discount when paying a lump sum of the accrued benefit derived from employee contributions before October 1, 2024, the plan is permitted but not required to redetermine the accrued benefit (without a preretirement

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mortality discount) when calculating the present value of any remaining portion of the accrued benefit.

For plans that want to be more generous by not applying a preretirement mortality discount when determining lump sums on the accrued benefit derived from employer contributions (so that, for example, a contributory plan could use the same factors for both the employee funded and employer funded portions of the accrued benefit), the final regulations allow this and provide such plans relief from the requirement that the qualified joint and survivor annuity must be the most valuable form of benefit offered to a married participant.

The regulations do not address whether a preretirement mortality discount can be applied in determining an offset for past lump sum distributions when calculating a residual annuity. (In 2023, the U.S. Court of Appeals for the Second Circuit addressed this issue in *McCutcheon vs. Colgate Palmolive*, ruling that when determining a residual annuity, a preretirement mortality discount was not permitted to be applied to amounts already received. The defendant's argument that this was at odds with the 2016 proposed regulations did not persuade the court otherwise.)

> **Buck comment.** Plans that offer lump sums on the accrued benefit derived from employee contributions will need to ensure that preretirement mortality discounts are not applied starting with annuity starting dates on October 1, 2024 or later.
>
> Sponsors of contributory plans that want to be more generous — by applying the regulations as of a date before October 1, 2024 or by redetermining the remaining accrued benefit without taking preretirement mortality into account on any lump sums on the accrued benefit derived from employee contributions paid before October 1, 2024 — may need to be amended to clearly provide for that. Sponsors who amend their plans to apply the new regulations for determining lump sum amounts that were already paid (after preretirement mortality was previously taken into account on the employee paid portion of the accrued benefit) may need to pay additional lump sum amounts.

Social security level income (SSLI) options

SSLIs are forms of payment that pay a part of the accrued benefit as a life annuity, with the remainder paid as a temporary annuity that ends when social security benefits are assumed to begin — so that the sum of the plan's benefit payments and the estimated social security benefit will yield approximately the same amount before and after the assumed social security commencement age.

Like the proposed regulations, the final regulations provide that because SSLI options decrease during the life of the participant at the assumed social security commencement age (for a reason other than the participant's death) and do not qualify as social security supplements, they are not exempt from the minimum present value requirements.

However, the final regulations now allow a plan to implicitly bifurcate a SSLI option into two parts under the partial annuity rules — so that only the temporary annuity portion is subject to the

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minimum present value requirements, and that the portion of the benefit that will continue to be paid over the remainder of the participant's lifetime after social security benefits are assumed to begin (if any), would not be subject to the minimum present value requirements. A plan that opts to use the implicit bifurcation rule for SSLI options must be amended to do so.

Note that the implicit bifurcation method for SSLI options requires two rules to be satisfied regarding the minimum amount of the non-temporary annuity portion of the benefit after adjustment for the temporary annuity amount — measured using the applicable interest rate and applicable mortality table. Under implicit bifurcation, the minimum must be met as of both the annuity starting date and at normal retirement age (or the current date, if later).

> **Buck comment.** Plan sponsors who were hoping that IRS would not subject SSLI options to the minimum present value requirements at all under the final regulations may now be forced to amend their plans and will be required to start applying the minimum present value requirements in operation effective no later than October 1, 2024 — increasing plan costs for offering these options going forward.
>
> Plan sponsors who had not amended their plan to apply the minimum present value requirements to the SSLI options may be able to blunt the impact of the increased costs by adopting an amendment to apply the implicit bifurcation approach allowed under the final regulations. Unfortunately, the IRS did not provide anti-cutback relief for plans that previously amended their plan to apply the minimum present value requirements to their SSLI options to allow them to switch over to the implicit bifurcation method.
>
> Plan sponsors who find the cost increase of applying the minimum present value rules to SSLIs to be unpalatable (even under the presumably less costly implicit bifurcation approach, if available) may wish to investigate the feasibility of amending their plan to eliminate one or more SSLI options that may qualify as "redundant" under the IRS anti-cutback regulations.

Changes to the anti-cutback relief under the one-year "greater of" rule

The final regulations retain the rules that allow a plan amendment to change the lookback months or stability periods for determining the applicable mortality table and interest rate for minimum lump sum purposes if the plan applies a "greater of" calculation (i.e., using either the old or new basis — whichever is more favorable to the participant) for at least one year. This rule still applies to changes in the lookback and stability periods that occur indirectly because of a change in the plan year, or a change that results from plan mergers.

Also, beginning January 19, 2024, if the one-year greater of rule is applied, a plan can adopt an amendment that changes a lookback month and stability period used to determine any interest rate or mortality table specified in the plan for any purpose — not just for determining the interest rates and mortality tables used for minimum present value purposes.

> **Buck comment.** Some plans applied lookback months and stability periods to determine the interest rates and/or mortality tables used for such things as converting a cash balance account

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to an annuity, or determining cash balance interest crediting rates (not just for determining minimum present value), and were permanently grandfathering the prior provisions because the anti-cutback relief provided by IRS limited the application of the one-year greater of rule to provisions concerning minimum present value. To simplify administration going forward, sponsors of such plans may now want to adopt an amendment to remove the permanent grandfathering of the old lookback month and stability period provisions after applying the one-year greater of rule.

While additional anti-cutback relief was sought by commentators, plans that have specified more generous calculation methods than are required under these regulations must maintain them for benefits already accrued.

Applicability date

The new regulations must be applied to annuity starting dates that occur on October 1, 2024, or later. Sponsors of contributory defined benefit plans can elect to apply the rules regarding the prohibition on applying preretirement mortality discounts to the employee paid portion of the accrued benefit can apply that rule earlier.

In closing

Generally, ERISA defined benefit plans that provide (or provided) for employee contributions and those that offer SSLI options must update plan operations to comply with the new rules for annuity starting dates on October 1 and later.

Sponsors of those plans may also need to update their plan documents to comply with the new regulations. When plan amendments are required, except as noted above (e.g., anti-cutback relief under the one-year greater of rule), generally such changes can be made retroactively after they are implemented. For example, for individually designed plans, any required plan amendments would have to be adopted by the end of the second calendar year after the change appears on the IRS required amendments list. If these final regulations appear on the 2024 required amendments list, such amendments would not be required until the end of 2026. If the plan sponsor adopts an optional change, such as if the plan did not previously say whether the minimum present value rules applied to SSLIs and the plan sponsor adopts an amendment to specify that the optional implicit bifurcation option rule will apply to SSLI options, the amendment would have to be adopted by the end of the plan year in which the amendment was made effective. It remains to be seen whether IRS will issue model amendments that plan sponsors can adopt to comply with these requirements.

The October 1 effective date does not leave much time for sponsors of these plans to make plan design decisions and for plan administrators (and their service providers) to implement any necessary changes. It may be wise to start discussions with service providers who perform benefit calculations sooner rather than later.

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