Legal Developments

IRS Rulings Permit Cashout of Pension Plan Retirees

Over the years, there has been a renewed focus on developing financial and benefit strategies to decrease the various risks and costs associated with pension plans, particularly in light of asset volatility, longevity of retirees, and changes in accounting and funding rules. In two recent private letter rulings—PLRs 201228045 and 201228051—the IRS has opened the door to a new way to eliminate ongoing defined benefit pension liabilities by simply giving pensioners a cashout option. While the concept is simple—amend the plan to provide a one-time election to take a lump-sum distribution—the devil is in the details, as the approach impacts a number of complex Code requirements, and careful administration of the election process is warranted.

BY ELIZABETH THOMAS DOLD

Elizabeth Thomas Dold is a principal attorney at Groom Law Group, chartered in Washington, D.C. For over 15 years, her work has focused on employee benefits and compensation matters, including employment taxes and related reporting and withholding requirements. She regularly advises Fortune 500 companies (including corporate and tax-exempt employers, financial institutions, and third party administrators) on plan qualification and employment tax issues. Ms. Dold is immediate past chairperson of the Information Reporting Program Advisory Committee (IRPAC) and a former adjunct professor at Georgetown Law Center.

One of the key legal hurdles with this approach is the minimum required distribution rules under Code Section 401(a)(9), which generally prohibit changes in the annuity stream for participants in pay status. A look at the rulings provides important relief and parameters for the new "derisking" approach.

PLR 201228045

The Economic Situation: The Company explained that its pension benefit obligations to its defined benefits plans and the obligations reported on the Company's financial statements are disproportionately large and very sensitive to swings in interest rates. Over time, these obligations have skewed disproportionately towards retirees. The Company's industry is susceptible to global economic changes. Swings in interest rates and changes in economic conditions have caused the pension obligations to be very volatile, which increases the cost of financing, making cash flow management (including contributions to the Plans) more difficult, and makes the Company less competitive in the global marketplace.

The Amendment: The Company proposed to amend its pension plans to permit a lump-sum payment option, during a limited window period, to the plans' participants and beneficiaries who have already commenced receiving an annuity. Notably, as with many traditional pension plans, there is no lump-sum option currently offered by the Plan. The terms of the amendment are as follows:

Who is eligible? The window is open to:

1. Participants currently receiving benefit payments;
2. Participants who have retired but have not begun receiving benefit payments;
3. Terminated deferred vested participants;
4. Beneficiaries who are receiving survivor benefits under the Plan or are eligible to receive survivor benefits; and
5. Alternate payees under a qualified domestic relations order.

Duration of the window? This is a one-time offer, and only open for a period of no less than 60 days and no more than 90 days.

What payment options are offered within the window? An individual may elect during the window period to receive a lump sum that represents the actuarial present value of his or her remaining benefits under the Plan at the time of the election, or to elect to receive, in lieu of the current annuity, the actuarial present value of the remaining accrued benefits under either a qualified joint and survivor annuity ("QJSA") or a qualified optional survivor annuity ("QOSA").

For participants/beneficiaries who are not in pay status, if they do not elect the lump sum or an immediate annuity during the window period, they will be eligible to elect an annuity form of benefit available under the applicable plan at benefit commencement.

Is spousal consent required to change the existing payments? Yes. And spousal consent must include both the current spouse and a former spouse if the annuitant has remarried since the annuity starting date when benefits initially commenced.

Is any assistance available in making the decision? Yes. Individuals are offered optional financial counseling provided by a highly reputable financial advisor.

The Legal Issue: The ruling addresses only whether the plan amendment violates Code Section 401(a)(9) regarding the minimum required distribution rules. These rules were designed to prevent lifetime accumulations that might escape income taxation altogether. [108 Cong. Rec. 18755, 18756 (1962)] For defined benefit plans, these rules require that all payments (whether paid over an employee's life, joint lives, or a period certain) must be nonincreasing. [Treas. Reg. § 1.401(a)(9)-6, Q&A-1(a)] However, the regulations further explain, in Q&A-14(a), that the annuity payments may increase as a result of certain listed exceptions, which expressly include "[t]o pay increased benefits that result from a plan amendment."

The ruling holds that for individuals in pay status, the proposed amendment will result in a change in the annuity payment period. Specifically, that the annuity payment period will be changed in association with the payment of increased benefits as a result of the addition of the lump-sum option. Moreover, individuals who wish to change their current distribution will be considered to have a new annuity starting date as of the first date of the month in which their new benefit is payable. Accordingly, the IRS ruled that, because the ability to select a lump sum will be available only during a limited window, the increased benefit payments will result from the proposed plan amendment and, as such, are a permitted benefit increase under the regulations.

Importantly, the ruling expressly states that it does not address any other tax consequences under the Code, including Sections 411, 415, 417, and 436 or of Title I of ERISA. These provisions, along with others, need careful consideration prior to rolling out a similar program.

PLR 201228051

The Amendment: The Company proposes to amend its traditional and cash balance pension plans to offer single-sum cash settlements of future annuity payments. Notably, as with many cash balance plans, there is already a lump-sum option currently offered by the Plan. The terms of the proposed amendment are as follows:

Who is eligible? The window is open to certain participants and beneficiaries in pay status.

Duration of the window? This is a one-time offer, and only open for a period of no less than 30 days and no more than 60 days.

What payment options are offered within the window? An individual may elect during the window period to receive a lump sum that represents the actuarial present value of his or her remaining benefits under the Plan at the time of the election, or to elect to receive, in lieu of the current annuity, the actuarial present value of the remaining accrued benefits under either a qualified joint and survivor annuity or a qualified optional survivor annuity.

Is spousal consent required to change the existing payments? Yes. And spousal consent must include both the current spouse and a former spouse if the annuitant has remarried since the annuity starting date when benefits initially commenced.

Is any assistance available in making the decision? Yes. Individuals are offered optional financial counseling provided by an independent financial advisor.

The Legal Issues: The ruling addresses three issues:

1. The applicable mortality tables that can be used,
2. The MRD rules under Code Section 401(a)(9), discussed above, and
3. Code Section 4974 regarding the 50 percent excise tax on failure to take minimum required distributions.

For the applicable mortality table, the IRS generally held that the plan sponsor can continue to use the plan-specific mortality tables approved previously by the IRS, provided that the actuary is able to certify that they remain accurately predictive of future morality of the Plan's population, as none of the five circumstances described in Treas. Reg. Section 1.430(h)(3)-2(d)(4)(i) are applicable. For the MRD issue, the ruling is nearly identical to the PLR previously described above, holding that Code

Section 401(a)(9) is not violated. Lastly, the IRS ruled that the implementation of the annuity settlement window will not trigger excise tax under Code Section 4974. The ruling noted that the portion of any lump-sum payment that was attributable to the required minimum distribution will be distributed to the participant and not treated as an eligible rollover distribution.

Importantly, the ruling expressly states that it does not address any other tax consequences under the Code, including Sections 401(a)(4), 411, 415, 417, and 436 or of Title I of ERISA. For example, as the window availability was more restricted that in the prior ruling, the nondiscrimination rules of Code Section 401(a)(4) are also listed, which include "benefits, rights, or features" (BRF) testing to ensure that the window does not favor highly compensated employees.

Accordingly, the ruling provides much-needed comfort regarding the minimum required distributions and mortality table rules and lays out a road map to follow with regard to this "derisking" approach. However, as noted earlier in this article, the devil is in the details. The various other Code restrictions require careful administration of the election process, including consideration of the following complexities:

- QJSA/QOSA and Spousal Consent. When considering the cashout option, it must also be accompanied by a right to an immediate annuity of a qualified joint and survivor annuity and a qualified optional survivor annuity. If the participant elects the cashout, he or she must waive the QJSA/QOSA in accordance with a qualified election, which generally includes a written explanation of the QJSA/QOSA provisions and notarized spousal consent. The ruling explains that for participants already in pay status, spousal consent is required of the initial spouse when benefits commenced, as well as the new spouse, if the participant has remarried.
- Benefit Accrual Limits. The payment of benefits cannot exceed the limitations of Code Section 415(b). For payments that are paid in other than a straight life annuity, this determination is made by adjusting the benefit so that it is equivalent to a straight life annuity, assuming specific interest and mortality assumptions. Moreover, the Regulations under Code Section 415 provide that, if a participant will have distributions commencing at more than one annuity starting date, the limitations of Code Section 415 must be satisfied as of each of the annuity starting dates, taking into account the benefits that have been provided at all of the annuity starting dates. [*See* Treas. Reg. § 1.415(b)-1(b)(iii).]
- Benefit Restrictions. For this approach, the funding levels of the plan must be sufficient so that the window program will not trigger benefit restrictions under Code Section 436, which includes limited lump-sum payments if the funding level (the "AFTAP") drops below 80 percent, and eliminates distribution opportunities while the AFTAP is below 60 percent.
- Interest Rates. A careful review of the rules under Code Section 417(e) is necessary to determine the applicable interest rates to be used for calculating the lump-sum payments.
- Reporting and Withholding Provisions. The lump-sum distributions are reported on Form 1099-R. To the extent that the participant elects to change his or her distribution option, various provisions need to be reviewed in order to comply with the applicable reporting and withholding provisions, including:

1. Whether Section 72(t) or the Section 72(t) recapture rule, which is the 10 percent tax on pre-age 59½ withdrawals, is triggered by the change to a lump sum,
2. What portion of the distribution is eligible for rollover treatment (and mandatory 20 percent withholding), for which a 402(f) notice (rollover notice) should be provided,
3. What portion of the distribution is a minimum required distribution that is not eligible for rollover and not subject to mandatory withholding,
4. Whether multiple 1099-Rs are required for a single participant (e.g., due to a change in the distribution codes in box 7), and
5. Whether the participant has any basis (e.g., after-tax contributions) in the Plan and how the taxable amount of the distribution is determined and reported on Form 1099-R.

- Small Cashouts. To the extent that the lump-sum option results in a small amount, the plan provisions regarding small cashouts should be reviewed. Cashouts of $5,000 or less do not require participant or spousal consent, and the QJSA and QOSA annuity options do not need to be provided.

A special distribution election package should be used for this purpose.

- Timing of Amendment/Cutback Issues. In order to comply with the anti-cutback provisions under Code Section 411, the new annuity options should not result in a reduction in the monthly benefits paid to the participants/beneficiaries, the amendment should be adopted prospectively, and the election materials should be written in a clear, neutral fashion, so the election process is purely voluntary.

In summary, as employers struggle to manage defined benefit plan costs in a competitive marketplace, we will continue to see innovative approaches to shift that liability away from employers, and this new cashout approach may be added to the mix of various "derisking" options and strategies. ■