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RETIREE CASHOUTS RAISE COMPLIANCE CONSIDERATIONS FOR PENSION PLANS

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In the wake of the recent IRS surprise decision to make it easier for defined benefit (DB) retirement plans to offer lump-sum windows to retirees and beneficiaries already receiving annuity payments, sponsors considering this risk-reduction strategy may want to take a closer look at issues that could complicate implementation. This article discusses the compliance considerations arising under the Internal Revenue Code (IRC) and ERISA, and reviews some of the key issues addressed in the handful of IRS private letter rulings (PLRs) issued on these windows.

MINIMUM DISTRIBUTION RULES

The required minimum distribution (RMD) rules of IRC Section 401(a)(9) generally prohibit changing the period or form of a distribution after payments have commenced, with certain limited exceptions (26 CFR § 1.401(a)(9)-6, Q&A-13 and -14). (Participants not yet receiving payments may be offered lump sums without running afoul of the RMD rules, but such programs raise other compliance issues beyond this article's scope.) According to the regulations, plans may offer retirees in pay status a new election only:

- In certain narrow situations, such as plan termination or various changes in a retiree's circumstances.
- In order to "pay increased benefits that result from a plan amendment," although it's never been clear what kind of benefit increase is required or whether a retiree's election to change the payment form could apply to the entire benefit rather than just the benefit increase.

Despite the regulations' lack of clarity, Ford Motor Co. successfully used the "increased benefits exception" in 2012 to obtain a PLR approving a one-time voluntary lump-sum cashout to retirees and beneficiaries already receiving payments. General Motors quickly followed suit with its own lump-sum window and favorable PLR. Several other plan sponsors later requested and received PLRs on similar programs.

EVOLVING IRS POSITION

The implementation of retiree lump-sum windows came to a screeching halt in 2015. In Notice 2015-49, IRS announced its intent to issue regulations generally prohibiting changes to the payout period once an annuity has commenced. In a surprising about-face, however, Notice 2019-18 now says that IRS will no longer take the position that a lump-sum window violates the minimum distribution rules.

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This latest reversal apparently opens the door for plan sponsors to move ahead with new offers. But sponsors hoping to get additional IRS reassurance that their windows pass muster are largely out of luck: The agency still won't issue PLRs in this area. Although IRS will no longer specifically exclude such windows from a determination letter, few sponsors may find that reassuring since determination letters now are generally available only upon initial plan qualification and termination.

Nonetheless, some plan sponsors may feel comfortable proceeding without a PLR, given the relatively permissive tone of the recent notice. But sponsors should take care to reduce the risk of challenges — from the government and participants — to their windows under other IRC and ERISA provisions.

TAX CODE AND ERISA ISSUES

The tax code, ERISA and related regulations have a host of requirements that can make implementing a cashout window difficult.

Determining Lump-Sum Amount

The lump sum must be at least equal to the IRC Section 417(e) present value of the remaining payments expected under the *current form* of payment — not the present value of the accrued benefit payable in the plan's normal form (typically a single-life annuity). (Sponsors could consider using a more generous lump-sum basis, but doing so may require increasing the qualified joint and survivor annuity (QJSA) offered to married participants (see the next section).)

The present value is determined as of the new annuity starting date (ASD). The lump sum must include any early retirement or optional form subsidies reflected in the current payment form.

Offering Required Payment Options at New ASD

A retiree's cashout election triggers a new ASD and the need to satisfy QJSA and qualified optional survivor annuity (QOSA) requirements (26 CFR § 1.401(a)(9)-6, Q&A-13(c)(2)). Thus, the cashout package often will not be as simple as a choice between a lump sum and continuing payments in the current payment form. Sponsors considering a retiree cashout must evaluate the financial implications of having to offer these distribution alternatives.

The implications of a new ASD depend on a participant's current marital status and payment form. While the many possible permutations are beyond the scope of this article, here are some key points to consider.

Married participants at new ASD. The package for participants who are married at the new ASD must include a QJSA and QOSA with the spouse as beneficiary. This holds true even if the participant had these options at the original ASD.

> *Example.* When Tony's pension began in 2013, he elected (with spousal consent) to receive a single-life annuity. A cashout package is offered in 2020. Tony is married at that time, so the package must include QJSA and QOSA options.

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> *Example.* When Carol's pension started in 2017, she elected to receive a QJSA. A cashout package is offered in 2020. Carol is still married to the same person. Her package must include a QOSA option.

Unmarried participants at new ASD. The package for participants who are unmarried at the new ASD must include the QJSA for unmarried participants, defined in the regulations as a single-life annuity. If the current payment form is already a single-life annuity, the cashout package may offer a simple choice between the lump sum and the current payment form. But if a participant has been receiving a non-QJSA form, such as a joint annuity with a nonspouse beneficiary, the cashout package apparently must include a single-life annuity option. If a participant has been receiving a life annuity with a period certain (that has yet to elapse), it's unclear whether the cashout package must include a single-life annuity that is actuarially equivalent to the remaining expected payments.

> *Example.* Steve, a married participant, retired in 2013 and elected to receive a $900 per month QJSA instead of a $1,000 per month single-life annuity. When Steve's wife died in 2017, Steve continued to receive $900 per month. A cashout package is offered in 2020, and Steve is unmarried at that time. The plan may offer Steve a simple choice between a lump sum and continuing the current $900 per month life annuity.

> *Example.* Natasha, an unmarried participant, retired in 2018 and elected a $950 per month life annuity with 10 years certain in lieu of a $1,000 per month single-life annuity. A cashout package is offered in 2020 when she has eight years remaining in the certain period. It's unclear whether Natasha's cashout package must include a single-life annuity with no guaranteed payments (which would deliver larger monthly benefits than her current payment form).

QJSA value. The QJSA can't be less valuable than any other form that's available at the same time. This means that if the lump sum is offered on a more generous basis than the 417(e) rates, the plan sponsor must evaluate whether the QJSA remains the most valuable option. Unfortunately, the regulations leave considerable uncertainty about how to apply the most valuable requirement. Many practitioners believe that using 417(e) rates for this purpose isn't necessary, so a plan sponsor might reasonably conclude that offering a lump sum on a more generous basis won't violate the most valuable rules. However, if the sponsor — in consultation with legal counsel — concludes that the lump sum is more valuable than the QJSA, the plan may also need to offer a new (bigger) QJSA actuarially equivalent to the lump sum.

Actuarially equivalent distribution options. Any required distribution options must be at least equivalent on a reasonable actuarial basis to the expected remaining payments under the current payment form. A plan could use its existing actuarial basis for this purpose. It isn't clear whether the amendment could instead specify new assumptions (such as the same 417(e) assumptions being used for the lump sum) that would apply only for the cashout package.

Limit on distribution options. A plan presumably may limit the distribution alternatives in the cashout package to those required by the QJSA and QOSA rules. For example, a plan that offered a variety of annuity options at the original ASD shouldn't have to offer all those options as part of the cashout package.

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Obtaining Spousal Consent

Married participants electing lump sums typically need spousal consent. Spousal consent requirements are complex, particularly for participants whose marital status has changed since the original ASD. Some participants may need consent from the spouse as of the original ASD *and* the spouse as of the new ASD. Here are some general principles, which are subject to any provisions of a qualified domestic relations order (or any valid waiver of spousal rights):

- *No change in marital status.* Participants married at the original ASD and still married to the same person at the new ASD generally need the spouse's consent to the lump-sum cashout.
- *Divorce after original ASD.* Participants currently receiving a QJSA with a former spouse generally need the former spouse's consent to switch to a lump sum. Participants currently receiving a non-QJSA payment form may have more flexibility because their former spouse has already relinquished consent rights.
- *Marriage after original ASD.* Participants married or remarried after the original ASD may need the current spouse's consent to waive the new QJSA/QOSA options in favor of a lump sum.

Complying With Section 415 Limits

The lump sum and any other distribution options offered as of the new ASD must comply with IRC Section 415 limits as of the new ASD. Demonstrating compliance for participants with large benefits might be difficult because IRS regulations — last updated in 2007 — reserved provisions on multiple annuity starting dates in response to pushback on a controversial proposed rule.

Administering Funding-Based Benefit Restrictions

The plan's adjusted funding target attainment percentage (AFTAP) must be at least 80% to pay full lump sums. (Partial lump sums are allowed for plans that are at least 60% but not 80% funded.) In addition, the plan amendment implementing the retiree cashout window must be tested for compliance with plan amendment restrictions. The AFTAP must remain at least 80% after taking into account any increase in the funding target due to the plan amendment (plus any additional contributions the employer makes to allow the amendment to take effect).

If lump sums are calculated using 417(e) assumptions, under the IRS "annuity substitution rule," the amount included in the funding target for retirees and beneficiaries expected to elect lump sums is the present value of the underlying annuity benefit — calculated using unisex mortality after the new ASD, rather than the sex-distinct mortality tables otherwise used to value annuities. The prescribed funding discount rate (not the 417(e) lump-sum discount rate) continues to be used to value the underlying annuity.

Thus, the difference between the annuity and lump-sum values is solely due to the difference in the mortality assumption. Whether the amendment increases or reduces the funding target depends on the population's makeup. If retirees and beneficiaries expected to elect lump sums are predominately male, the amendment will likely increase the funding target. But if they are predominately female, the amendment might reduce the funding target.

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If lump sums are calculated using subsidized assumptions, the funding target must include the value of the subsidy, so plan amendment restrictions are more likely to be triggered.

For plans at least 80% but less than 100% funded, paying lump sums typically reduces the following year's AFTAP, absent additional employer contributions. If retiree cashouts are implemented in phases spanning more than one plan year (see below), retirees in later phases — or actives retiring in the future, if given a lump-sum option — might be limited to partial lump sums.

While navigating these AFTAP rules, plan sponsors also must evaluate how the "high 25" restrictions — limiting the size of annual payments to an organization's 25 highest-paid current or former highly compensated employees — might apply to the newly offered lump sums.

Determining Whether Participants Owe a Penalty Tax

The 10% penalty tax on early distributions may be a concern for any participants who terminated employment before Jan. 1 of the year they turned age 55 and started receiving payments before age 59-1/2 (Notice 87-13, Q&A-20). Participants in this group are exempt from the penalty tax as long as they receive payments in the form of a life annuity. That exemption would be lost if they elect a lump sum.

The consequences of losing the exemption are twofold: First, the lump sum generally would be subject to the penalty tax if received before age 59-1/2 (and not rolled over to an IRA). Second, a recapture tax may apply to earlier annuity payments if the annuity stream is discontinued before age 59-1/2 or within five years after it began (whichever is later).

Implementing Cashouts in Multiple Phases

Depending on the size of the retiree population, recordkeepers may be unable to process lump-sum elections in a single batch. As a result, employers may need to structure the offering in two or more tranches, perhaps spanning more than one plan year. This means some retirees will have access to lump sums earlier — or at different market interest rates — than their peers, so employers may want to establish an equitable method for assigning retirees to particular tranches. (Ford assigned participants randomly, based on the last two digits of their Social Security number.) Here are some of the tax issues to consider:

- Will all groups will pass muster under IRS nondiscrimination rules? (Nondiscrimination testing for windows is complex and beyond the scope of this article.)

- Could participants in later groups be limited to partial lump sums — due to IRC Section 436's accelerated benefit restrictions — after those in the earlier groups are paid in full?

- How would participants in later groups be affected by a change in the applicable interest rate?

Accounting considerations. Employers should confirm the accounting treatment with auditors:

- *US GAAP.* For sponsors reporting under US generally accepted accounting principles (GAAP), settlement accounting is generally required if the liability settled is greater than the sum of the plan's

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service cost plus interest cost. By offering lump sums in multiple tranches, companies may be able to keep the amount settled each year below this threshold. However, this strategy may not work if retiree liabilities constitute the bulk of total pension liabilities and a significant number of retirees opt for the lump sum. Successfully implementing this strategy requires careful tranche design as elections made by retirees in early tranches will affect the settlement accounting threshold for later tranches.

- *IAS 19.* Employers reporting under International Accounting Standard 19 don't face the same threshold issue: The change in funded status arising from lump-sum windows are generally recognized in P&L immediately (pre-existing lump-sum provisions are excluded from this calculation).

Instead of offering lump sums in multiple tranches, employers that want to avoid settlement accounting might consider offering retirees a one-time right to elect annual installments over a set period, such as five years. This might keep the payments in a given year below the settlement accounting threshold. And some auditors take the position that only the final installment settles the liability — installments paid in early years do not count toward the settlement threshold in those years. Other auditors treat each installment as settling a portion of the liability, requiring annual assessment of whether settlement accounting is required.

Offering Cashouts Only to Select Groups

Some employers might consider making the cashout offer only to select retiree groups. For example, offering lump sums to retirees with small annuities (say, less than $10,000 annually) could significantly reduce PBGC premiums and per-participant recordkeeping charges, even if it does little to reduce balance-sheet volatility. On the other hand, offering lump sums primarily to retirees with large annuities could have a material balance-sheet impact but probably wouldn't pass muster under IRS nondiscrimination rules: The availability of the lump-sum option must not discriminate significantly in favor of former highly compensated employees.

Some employers might consider limiting the select group to participants under a specified age. But that approach might raise concerns under the Age Discrimination in Employment Act and should be discussed with legal counsel. As an alternative, some employers have limited eligibility to more recent retirees.

Communicating With Participants and Beneficiaries

Given the importance of this decision, accurate and balanced communications are essential. Moreover, plan administrators must meet QJSA notice requirements and give participants and beneficiaries a reasonable period to review their options before making a decision.

In some respects, a retiree cashout option isn't all that different from a lump sum offered in the ordinary course at early or normal retirement age: Employers must describe the financial effect of the election for the participant and spouse, disclose the relative value of all available optional forms of payment, supply a rollover notice and be sure participants have access to relevant parts of the summary plan description (including the explanation of PBGC coverage). Employers also should identify factors that could reasonably be expected to affect the participant's decision-making, such as loss of eligibility for retiree health coverage.

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Some employers might consider more robust communications or financial counseling — highlighting risks associated with mortality, longevity, investment, inflation, etc. — given many retirees' advanced age and lack of regular contact with the plan administrator (other than receipt of a monthly check and annual funding notice).

Evaluating Impact on Nonqualified Plans

Many employers maintain nonqualified deferred compensation (NQDC) plans that are coordinated with qualified pension plans. The impact on NQDC plan administration is complicated and beyond the scope of this article. Typically, employers need to consider whether NQDC benefits may be cashed out without violating Section 409A or materially modifying benefits grandfathered under Section 409A.

Adverse Selection

Although adverse selection technically is not a compliance issue, plan sponsors will still want to consider its potential financial impact — that is, the likelihood that individuals who believe they will live longer than average will choose annuities, while people who expect to live shorter than average will choose lump sums. Under this scenario, plans may lose some of the benefit of risk pooling and face increased overall costs: The plan will pay "full" value to people who otherwise might have received annuity payments for only a short period, while continuing to pay annuities for an extended period to the remaining participants.

Insurers will likely adjust pricing to reflect adverse selection if annuities are being purchased for a group of retirees who were recently offered a lump sum and turned it down. Even if no annuity purchase is contemplated, the increase in average longevity of the remaining participants may still increase plan sponsor costs. Adverse selection is typically more pronounced the older the group in question, although the effect is also influenced by other factors, such as how many retirees take the lump-sum offer and whether they were originally eligible for a lump sum at retirement.

POSSIBLE ROADMAP IN PLRs

The PLRs released in 2012 and 2014 are substantially similar to each other and reached the same conclusion: The cashout offers didn't violate the RMD rules of IRC Section 401(a)(9). But the plans obtaining PLRs had a couple of noteworthy differences in the treatment of lump-sum calculation methods and financial counseling for participants.

Lump-Sum Calculation Methods

In the rulings that followed Ford and GM's, IRS went out of its way to state it was not opining on whether the lump-sum calculation method satisfies the minimum present value requirements of Section 417(e). It is unclear whether this is simply a jurisdictional issue — compliance with 417(e) should be handled through the determination letter program, not through PLRs — or whether the IRS staff was unable to reach a consensus position on 417(e) compliance in retiree cashouts.

All the rulings describe the lump sum as the actuarial value of the participant's remaining monthly benefits, calculated at the time of the election. This method is consistent with IRS sample plan amendments automatically providing retirees who started annuity benefits when lump sums were restricted under Section 436 with a lump-sum election once restrictions are lifted.

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However, in various informal discussions, IRS staff have suggested that paying the present value of remaining monthly payments under the current annuity form might not satisfy 417(e) if the present value of the participant's accrued benefit payable at normal retirement age, adjusted for payments actually received, is higher (see item 4 in Notes from Intersector Meeting with IRS/Treasury, March 12, 2014). This situation can arise when a plan's early retirement reductions exceed actuarially equivalent reductions using 417(e) assumptions, or when a participant elected a joint and survivor annuity option but the joint annuitant died before the cashout was offered.

On the flip side, some practitioners have suggested that 417(e) rules might allow plans to offer retiree lump sums that are less than the present value of remaining annuity payments by excluding this subsidy from the lump sum when the annuity includes early-retirement or optional-form subsidies. None of the sponsors that obtained favorable PLRs took this approach, and sponsors considering this approach are advised to proceed with caution: A sponsor calculating lump sums in this fashion could face exposure to ERISA lawsuits filed by participants who believed they were shortchanged.

Financial Counseling for Participants

In the Ford and GM rulings, both companies represented that cashout-eligible participants would be offered financial counseling from independent, reputable advisors. At that time, it was unclear whether IRS required that financial counseling be offered as a condition of obtaining a favorable PLR. But some of the later rulings are silent on the issue, suggesting that IRS didn't require an offer of financial counseling for a favorable PLR (although the PLRs focused narrowly on compliance with the RMD rules).

Even if financial counseling isn't required, it might be considered a best practice to minimize litigation risk.

Other Common Features

The PLRs illustrate several other features common to all rulings:

- Lump-sum cashouts were offered on a one-time basis, not as a permanent plan feature. The window periods for making lump-sum elections were 30–60, 60–90, 30–90 or up to 180 days.

- Participants apparently may elect to roll over lump-sum distributions to an IRA or another plan, even though the cashouts are replacing an annuity stream that's ineligible for rollover (see 26 CFR § 1.402(c)-2, Q&A-5(c), calling for a new determination of rollover eligibility when payment amounts change). But the rollover must exclude any RMDs for the distribution calendar year (as determined under 26 CFR § 1.401(a)(9)-6, Q&A-1(d)). The PLRs clearly contemplate that the lump-sum cashouts would otherwise be eligible for rollover, even though IRS didn't explicitly address that point.

- All the plan sponsors represented that funding levels were sufficient so that implementation of the cashout amendment "will not trigger benefit restrictions described in Section 436."

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RELATED RESOURCES

Non-Mercer Resources

- Notice 2019-18 (IRS, March 6, 2019)
- Notice 2015-49 (IRS, July 9, 2015)
- Notes from Intersector Meeting with IRS/Treasury (American Academy of Actuaries, March 12, 2014)

Mercer Law & Policy Resources

Links to resources in the Mercer Select archive are accessible to Mercer consultants. Clients may contact their consultants for free copies:

- IRS Revives Retiree Lump-Sum Windows in Defined Benefit Plans (March 7, 2019)

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