GROOM LAW GROUP
CHARTERED

BENEFITS BRIEF

January 13, 2017 www.groom.com

If you have questions, please contact your regular Groom attorney or one of the attorneys or professionals listed below:

Mark E. Carolan
mcarolan@groom.com
(202) 861-5424

Mark L. Lofgren
mlofgren@groom.com
(202) 861-6614

Louis T. Mazawey
lmazawey@groom.com
(202) 861-6608

Joshua Shapiro*
jshapiro@groom.com
(202) 861-2613

Jeff Witt
jwitt@groom.com
(202) 861-6651

**Senior Actuarial Advisor*

Proposed New IRS Mortality Table May Impact Plan Funding and Benefit Payouts

The IRS and Treasury recently proposed new regulations on the mortality tables for defined benefit retirement plans. 81 Fed. Reg. 95911 (Dec. 29, 2016). The proposed regulations include a new mortality table and mortality improvement scale, which have been anticipated in recent years. The new table generally provides for lower mortality rates than the table currently in use, which in turn increases the calculated present value of plan liabilities. Once finalized, this change will apply to minimum funding calculations for single-employer plans and will be used by the IRS as the basis to publish a new mortality table to be used to calculate the minimum present value for lump sum distributions to plan participants as required under Code section 417(e). The proposed regulations also relax the requirements for plan sponsors to use a substitute mortality table, which may allow many plans to avoid using the new IRS-prescribed mortality table for funding purposes.

In light of this proposed regulation, plan sponsor may want to consider taking the following steps in the coming months:

- Review updated projections of minimum funding and PBGC premium requirements taking into account the proposed mortality table
- Evaluate whether the sponsor might be eligible to use a substitute mortality table, and whether doing so would result in savings
- Determine the potential impact of the new tables on possible de-risking strategies
- Consider how this may impact ongoing plan administration and benefit distribution calculations after the IRS issues the new Code section 417(e) table for minimum lump sum distribution purposes (some plans use the 417(e) table for both lump sum calculations, as well as for calculating certain annuity forms of distribution)

The proposed regulations would apply for plan years beginning on or after January 1, 2018. The IRS has requested comments by March 29, and has scheduled a public hearing for April 13. Under these proposed rules, if any sponsor wanted to use a substitute mortality table for a 2018 calendar year plan, the written filing to the IRS would be due by June 1, 2017.

Background

Most sponsors of defined benefit plans are subject to minimum funding rules under Section 430 of the Code. For these plans, the minimum required contribution is determined using a mortality table provided by the IRS. The current mortality table, which is the RP-2000 table, has been used since the Pension Protection Act ("PPA") rules became effective in 2008. This mortality table is also used, with some adjustments, to calculate the minimum lump sum value of a participant's benefit when a plan offers lump sums (Code sec. 417(e)). The current table is also updated annually to reflect mortality improvements using the Society of Actuaries' Scale AA.

The PPA also required that the mortality table be updated at least every 10 years to reflect actual mortality experience of pension plan participants and projected mortality trends. An updated mortality table was developed by the Society of Actuaries ("SOA") in 2014, called the RP-2014 mortality table. The SOA also developed a new mortality improvement scale in 2014, called MP-2014. The SOA updated the improvement scale in 2015 and 2016, with the MP-2016 being the most current version.

Current law allows a plan sponsor to use a substitute mortality table that reflects the sponsor's own mortality experience. However, current regulations make it difficult for all but the largest plan sponsors to utilize this alternative. Although there are several requirements to use a substitute table for both male and female participants, one of the most onerous is that the plan population must have had at least 1,000 deaths for each gender in a recent five-year period. While a plan can be aggregated with the sponsor's other plans to satisfy this requirement, this essentially limits this option to only large plans with significant mortality data.

If the plan-specific mortality table is approved by the IRS, the sponsor can use that table for Code section 430 purposes (generally, for the minimum required contribution). However, the plan-specific table cannot be used for calculating minimum lump sum payments.

New Mortality Table and Mortality Improvement Factors

Under the new IRS and Treasury proposal, the current RP-2000 mortality table would be replaced by the RP-2014 table, and Scale AA would be replaced by MP-2016. The net effect of these changes is expected to increase liabilities. Based on analysis performed by the Society of Actuaries, a very rough estimate is that a typical plan might see a liability increase of around 5% due to the new tables. The actual impact, however, is likely to vary significantly across plans, and it is necessary for an actuary to measure the liabilities using the new tables to determine the exact amount. The following factors may be relevant to the impact on a particular plan:

- **<u>Age Distribution</u>:** All else being equal, plans with younger populations will have a larger increase in liabilities than plans with older participants.

- **<u>Gender Distribution</u>:** Generally, plans with a greater proportion of female participants (who have longer life expectancies) will have a larger increase in liabilities.

- **<u>Plan Type</u>:** Cash balance plans, and other similar plan types that define accrued benefits as lump sum amounts, will see significantly less of an impact, as the lump sums in those plans typically do not depend on mortality assumptions.

The increase in liabilities that is expected to occur for most plans could lead to the following consequences:

- **<u>Increased Minimum Required Contributions</u>:** Most plan sponsors can expect to have higher minimum required contributions and quarterly contributions under the proposed mortality tables. The primary exception is likely to be cash balance and other similar plans, where the increase in liabilities will be far less significant than it is in other plans.

- **<u>Higher Lump Sums</u>:** For plans that define their benefit as an annuity, the new mortality provisions will assume a longer lifetime for the annuitant (or annuitants), making a lump sum distribution more expensive for these plans. This effect will generally not apply to cash balance and other similar plans, since they define the accrued benefit as a lump sum, as opposed to calculating lump sums as the present value of an annuity.

- **<u>Lower Funded Status</u>:** With the increased liabilities and no corresponding change to plan assets, the funded level of a plan will decrease. This could trigger benefit accrual restrictions and/or limitations on lump sum distributions under Code section 436, as well as PBGC reporting under ERISA section 4010.

- **<u>Increased PBGC Premiums</u>:** PBGC's variable-rate premiums (for single-employer plans), which are based on unfunded vested benefits, depend on the funded level of the plan. Thus, as liabilities increase under the new mortality provisions, plan sponsors subject to PBGC's variable rate premiums likely will owe more to the PBGC.

Plan-Specific Mortality Tables and Key Considerations

The proposed regulations also change the requirements for a plan to use a substitute mortality table based on the plan's own mortality experience. As noted earlier, a plan currently needs to have 1,000 deaths for a particular gender observed within a five-year period in order to develop its own substitute mortality table and request IRS approval of the table in the form of a private letter ruling. The proposed rules would allow a sponsor to use a substitute table if it has only 100 deaths for a particular gender within that five-year period. Using a substitute table for both male and female mortality requires 100 deaths for each gender. According to the Preamble, the IRS and Treasury "expect significantly more plan sponsors to request the use of substitute tables after [these proposed rules become] effective."

Generally, the substitute table is the IRS's "applicable mortality table" (RP-2014), multiplied by a mortality factor. The factor is a ratio, which is designed to reflect the benefit-weighted mortality experience of the plan. The factor is essentially adjusted based on how much mortality data each plan has observed. If a plan has full credibility, it may use the entire mortality factor adjustment, which could cause a large deviation from the RP-2014 table. Full credibility requires a five-year experience period that includes 1,082 deaths, with an actuarial adjustment to this figure that reflects the extent to which benefits vary across the plan population. If a plan has only partial credibility, which requires at least 100 deaths, then the mortality factor is scaled down and the substitute table more closely resembles the RP-2014 table.

If the substitute table is approved by the IRS, it can only be used for the length of time specified in the written submission, not to exceed 10 years. If, during that period, there is a 20% increase or decrease in plan population, the plan cannot continue to use the substitute table unless the plan actuary certifies that the substitute table continues to be accurate despite the change in the population. In addition, if the substitute table is approved for one plan, then all of the defined benefit plans within the sponsor's controlled group must use a substitute table (unless such plan cannot meet the credibility requirements to use a substitute table).

These new rules would allow many more plans to use substitute mortality tables, which for some plans may come as a welcome alternative to using the new RP-2014 mortality table. The ultimate effect of the substitute table will vary from plan to plan, but it could materially affect a plan's funded status. We expect that many plans will evaluate the impact of a substitute table to determine if it raises or lowers the liability results, and then decide whether to apply to the IRS based on those findings. As mentioned above, this could potentially have many favorable consequences for a plan sponsor (lower minimum required contributions, avoiding PBGC reporting, lower variable rate PBGC premiums).

However, the substitute tables are complex to develop and may require a substantial amount of technical actuarial work. There is also no guarantee that the IRS will approve the substitute table even after it is developed. In addition, the IRS reserves the authority to disallow the use of an approved substitute table if the IRS believes that it no longer accurately predicts the future mortality of the population.
Plan sponsors may want to work with their actuarial consultants to carefully examine how a substitute table would impact their funded status, and whether they could satisfy the applicable criteria to have the substitute table approved by the IRS. For the plan year starting on January 1, 2018, the June 1, 2017 filing deadline is quickly approaching.

Possible De-risking Options for 2017

For plan sponsors that are considering de-risking activities (e.g., lump sum distribution window or purchase of annuity contracts to satisfy a portion of its benefit obligations), it will be critical to consider the impact of these changes. Beginning in 2018, these new tables could have a significant impact on the valuation of plan liabilities as well as on the present value of benefits to participants. Plan sponsors may want to review how these changes could specifically affect their plan before deciding if and when to implement a de-risking strategy. Other factors complicating these decisions include possible changes in interest rates, which could affect insurance company annuity rates, as well as the present value of lump sum distributions. Insurance companies also have limited capacity to issue annuity contracts, and if the proposed regulation creates a surge in demand, it could adversely affect availability and pricing. Additionally, the combination of the proposed regulation and the de-risking activities of plan sponsors could attract negative media attention that may be a consideration for some sponsors. Thus, a lot of moving parts should be analyzed before deciding on an approach.