Employee Benefits Corner

By Elizabeth Thomas Dold and David N. Levine

A Look at Retiree Cashouts as the New "De-Risking" Strategy

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In recent years, plan sponsors have been focusing on possible financial/benefit strategies to "de-risk" their defined benefit pension plans. The focus on "de-risking" arises primarily because of increased asset volatility, increased retiree longevity, recent changes in accounting and funding rules, concerns about ongoing benefit liabilities and their potential impact on the value of the plan sponsor's securities, and the general decline of defined benefit pension plans. Still other factors include increasing PBGC premiums under the recent "MAP-21" guidance and communication costs for inactive participants.

The concept of de-risking includes more "traditional" strategies such as liability-driven investing and annuitizing accrued benefits (which can be more costly, but completely shifts the liability risk to a third party) and the recently popular "annuity buy-in" where an insurer and plan sponsor share financial risks. Still another way to manage risk is to cashout pensioners altogether, effectively shifting the investment and longevity risks to them. Two recent IRS private letter rulings signal that the minimum distribution rules don't stand in the way of this technique. Below we describe these private letter rulings—LTR 201228045 and LTR 201228051[1]—and provide an additional review of other legal and administrative complexities involved with lowering the cost of defined benefit plans through a one-time cashout option to former participants.

The Rulings

In LTR 201228045, the company proposed to amend its plan to offer a one-time lump-sum option to former participants, including retirees in pay status. The ruling requested a determination that this feature does not violate the Code Sec. 401(a)(9) required minimum distribution rules for participants and beneficiaries in pay status. 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.[2] 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 IRS held that the one-time window did not violate the minimum required distribution requirements, and cited the legislative history of the provision, that these rules where designed to prevent lifetime accumulations which might escape income taxation altogether, which is not a concern here.[3] Specifically, the ruling holds that for individuals in pay status, the proposed amendment will result in a change in the annuity payment period. 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. 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. Therefore, the IRS ruled that because the ability to select a lump sum will only be available 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.

Table 1.

	LTR 201228045 [Likely the *Ford* Ruling]	LTR 201228051 [Likely the *General Motors* Ruling]
The Plan	Traditional pension plan, with no lump sum offered. The Company explained that its pension benefit obligations to its defined benefits plans and the obligations reported on the Company's financial statements were disproportionately large, very sensitive to swings in interest rates, and skewed disproportionately towards retirees.	Traditional and cash balance plans, where the cash balance plan already offered a lump-sum option as a distribution option.
The proposed amendment	One-time offer of lump sum that represents the actuarial present value of their remaining benefits under the Plan at the time of the election.	One-time offer of lump sum that represents the actuarial present value of their remaining benefits under the Plan at the time of the election.
Eligibility	(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.	Only certain participants and beneficiaries in pay status.
Duration of the window	60–90 days	30–60 days
Annuity options	QJSA and QOSA	QJSA and QOSA
Spousal consent	Current and former spouse (at the time of the initial annuity starting date), if different.	Current and former spouse (at the time of the initial annuity starting date), if different.
Assistance offered in making the election	Yes, optional financial counseling from highly reputable financial advisor.	Yes, optional financial counseling provided by an independent financial advisor.
Legal issues addressed	Code Sec 401(a)(9)—required minimum distributions' prohibition against increasing payments.	Code Sec. 401(a)(9)—required minimum distributions' prohibition against increasing payments. Code Sec. 4974—50% excise tax on failure to take minimum required distributions. Applicable mortality tables that can be used.
Legal issues not addressed	Code Secs. 411, 415, 417 and 436; Title I of ERISA	Code Secs. 401(a)(4), 411, 415, 417 and 436; Title I of ERISA

Similarly, in LTR 201228051, the company proposed to amend its defined benefit plans to offer a single-sum cash settlement of future annuity payments. The ruling requested that the IRS address three issues: (1) the applicable mortality tables that can be used; (2) the required minimum distribution rules under Code Sec. 401(a)(9), discussed above; and (3) Code Sec. 4974 regarding the 50-percent excise tax on failure to take minimum required distributions.

Regarding the applicable mortality table ruling request, the IRS generally ruled that the plan sponsor could 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. The IRS explained that this approach was appropriate because none of the five circumstances described in Reg. §1.430(h)(3)-2(d)(4)(i) were applicable.

With respect to the required minimum distribution issue, the ruling is nearly identical to LTR 201228045 described above. It held that Code Sec. 401(a)(9) was not violated because the amendment fell within the exception provided by the regulations "[t]o pay increased benefits that result from a plan amendment."

Finally, the IRS ruled that the implementation of the annuity settlement window would not trigger the 50-percent excise tax under Code Sec. 4974 for failure to comply with the minimum required distribution rules. Notably, the ruling stated that the portion of any lump-sum payment that was attributable to the required minimum distribution would be distributed to the participant and not treated as an eligible rollover distribution.

The key provisions of the private letter rulings (which can only be relied on by the companies that received them) are outlined in Table 1.

Other Legal and Administrative Considerations

A cashout approach for de-risking involves a number of legal and administrative considerations prior to implementation. The private letter rulings address the required minimum distribution rules, and provide guidance on the applicable mortality tables, but there are many other legal and administrative steps involved in the process. The private letter rulings expressly provide that they do not address any other tax consequences under the Code, including Code Secs. 401(a)(4), 411, 415, 417 and 436 or of Title I of ERISA. These complex Code provisions are briefly described below:

- **Nondiscrimination Requirements (Code Sec. 401(a)(4)).** Tax-qualified plans may not provide contribution or benefits under the plan that discriminate in favor of highly compensated employees under Code Sec. 401(a)(4). For example, if a one-time window option is not provided to all participants/beneficiaries in pay status, then the window will likely be subject to nondiscrimination testing, such as "benefits, rights, or features" (also known as BRFs) testing to ensure that the window does not favor highly compensated employees.
- **Accrued Benefit Not to Be Decreased by Plan Amendment (Code Sec. 411(d)(6)).** Tax-qualified plans are generally prohibited from decreasing a participant's accrued benefit by an amendment to the plan under Code Sec. 411(d)(6)—the Code's anti-cutback provision. Therefore, a one-time window option may not result in a decrease in the participant's accrued benefit. For example, any new annuity options should not result in a reduction in the monthly benefits paid to participants or beneficiaries, an amendment should be adopted prospectively, and the election materials should be written in a clear, neutral fashion, so the election process is purely voluntary.
- **Benefit Limits (Code Sec. 415).** Tax-qualified plans are limited in the amount of benefits that can be paid from the plans under Code Sec. 415. Specifically, for defined benefit plans, the benefit payments cannot exceed the limitations of Code Sec. 415(b), which involves taking into account the participant's prior benefits, with the added complexity of multiple annuity starting dates. For lump-sum payments, 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, Reg. §1.415(b)-1(b)(iii) provide that if a participant will have distributions commencing at more than one annuity starting date, the limitations of Code Sec. 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.
- **QJSA/QOSA and Spousal Consent (Code Sec. 417).** Tax-qualified defined benefit plans are required to offer as the normal form of benefit a qualified joint and survivor annuity, with at least 50 percent of the amount paid to the participant to be

paid to the surviving spouse (a QJSA), along with a qualified optional survivor annuity (a QOSA) under Code Sec. 417. There are also complex notice and consent provisions that apply in the event that the participant and spouse elect to waive these forms of benefits in favor of a lump-sum option. Moreover, the QJSA form of benefit must be at least as valuable as any other form of benefit based on reasonable actuarial assumptions. Therefore, for a cashout option, it must be accompanied by a right to an immediate annuity of a qualified joint and survivor annuity and a qualified optional survivor annuity. If a participant elects to receive a 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 private letter rulings 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, which necessarily adds another level of complexity to the process.

- **Interest Rates for Lump Sums (Code Sec. 417(e)).** For tax-qualified plans, the minimum amount that can be distributed in a lump sum is based on certain interest and mortality assumptions under Code Sec. 417(e). The prescribed lump-sum interest rate is based on a "stability period" and the IRS rate published for the "look-back month." Therefore, for this approach, a careful review of the rules under Code Sec. 417(e) is necessary in order to determine the applicable interest rates and mortality assumptions to be used for calculating the lump-sum payments.
- **Benefit Restrictions (Code Sec. 436).** The Pension Protection Act of 2006 (PPA) added restrictions on providing lump sums depending on the Plan's funding level under Code Sec. 436. Accordingly, to adopt an amendment permitting lump-sum cashouts, the funding levels of a plan must be sufficient so that the window program will not trigger benefit restrictions under Code Sec. 436, which generally means that to offer a cashout option, the plan's funding level (commonly referred to as the "AFTAP") may not drop below 80 percent (100 percent for plan sponsors in bankruptcy).

In addition to these legal considerations, employers face substantial communications and other hurdles presenting this option to retirees and administering the election process. Potential items to consider include the following:

- **Participant Communication.** Plan fiduciaries have a fiduciary obligation to provide sufficient information to assist retirees in making an informed choice. As such, clear communications are necessary. In the private letter rulings, these efforts apparently included the help of financial advisors to make an informed decision.
- **Union Approval.** For plans subject to collective bargaining, union approval may be required.
- **Preparation of Election Packages.** A key step in the process is the calculation of the benefits that will be available to each participant/retiree/beneficiary. The administrative process of creating, mailing and processing the election packages as well as the contents of the election packages, and the various disclosures, consents, rollover options, withholding elections and applicable time restrictions make the features described in the private letter rulings a complex process. Also, to the extent that a lump-sum option results in a small amount, a special election package may be needed as special rules apply to payments under the cashout limit. Importantly, this process also typically includes developing online tools and resources for participants, and setting up call centers for questions.
- **Reporting Distributions.** The distributions must be reported on Form 1099-R, and the withholding treatment varies on the type of payment, whether it was eligible for rollover treatment, whether it was directly rolled over to a plan, traditional IRA, or a Roth IRA, and any withholding election made. The impact of Code Sec. 72(t), the 10-percent tax on early withdrawals (and its five-year recapture provision) must also be considered, as well as the impact to any basis recovery (*e.g.,* after-tax contributions) for tax-free benefits.

Conclusion

Recent press reports on use of Ford's and General Motors' strategies suggest that the above rulings were issued to them. General Motors' strategy includes a broader strategy of annuitizing and terminating the plan covering only inactive participants. This approach makes sense given the huge retiree populations of these longstanding major companies. Notably, a number of other large companies have also indicated that they intend to adopt these or similar strategies in the near future.

Pension policymakers may be concerned that this strategy is going in the wrong direction from the participant's perspective. Whether policymakers will weigh in on the total cashout approach to de-risking remains to be seen. Meanwhile, plan sponsors continue to evaluate de-risking options and strategies, with the addition of the cashout option in the effort to reduce the cost and size of pension plans, and gain the benefit of reduced PBGC premiums, simplify risk management, lower ongoing plan administrative costs and possibly facilitate a subsequent plan termination, while reducing the market and longevity risks associated with providing lifetime benefits to participants and their beneficiaries.

Endnotes

1 LTR 201228045 and LTR 201228051 (Apr. 19, 2012).
2 Reg. §1.401(a)(9)-6, Q&A-1(a).
3 *See* 108 Cong. Rec. 18755, 18756 (1962).