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IRS Shuts the Door on Lump Sum Windows for Retirees

On July 9, 2015, the IRS issued Notice 2015-49, effectively overturning a stream of Private Letter Rulings issued since 2012 (the widely known Ford/GM Rulings) where the IRS had ruled that a qualified defined benefit plan could be amended to permit a participant in pay status to elect to commute the remaining value of the annuity payments to a lump sum payment during a temporary "window period." This type of amendment – to permit participants/beneficiaries in pay status to elect a lump sum that was not otherwise available under the terms of the plan – is often referred to as a "de-risking" amendment and is no longer permitted, generally effective July 9, 2015. Importantly, plan sponsors can continue to provide these lump sum windows for participants that are not in pay status (e.g., deferred vested participants).

This change in position is likely tied to government concerns that retirees are ill-prepared to manage lump sum distributions and the view that continued lifetime pension payments are a critical part of an individual's financial security during the retirement years. Moreover, we suspect the Notice is primarily a result of continued lobbying by retiree groups to get some action at a policy level to slow this trend. The release was certainly kept under close wraps – unlike most published guidance in development. As a result of this Notice, plan sponsors can no longer transfer the risks of increased longevity and investment loss to participants already in pay status. The IRS will be issuing proposed regulations to clarify the scope of this new restriction.

Background

In the past few years, many plan sponsors have been focusing on financial/benefit strategies to "de-risk" their pension plans. The focus on "de-risking" arises primarily because of:

- increasing asset volatility,
- increased retiree longevity (and pending mortality table changes),
- recent changes in accounting and funding rules, and
- concerns about ongoing benefit liabilities and their potential impact on the value of the plan sponsor's securities.

Still other factors include increasing PBGC premiums under the recent highway legislation 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 costly, but completely shifts the liability risk to a third party), and the newer "annuity buy-in" where the insurer and plan sponsor share the risks. At issue here is the method to manage risk by cashing out pensioners altogether, effectively shifting the investment and longevity risks to them.

One significant area of uncertainty with regard to de-risking has been whether a lump sum option could be offered to participants in pay status. Treas. Reg. section 1.401(a)(9)-6, Q&A-1(a) states that once payments begin, they cannot be changed and must be non-increasing. However, there are exceptions to this general prohibition. As relevant here, Treas. Reg. section 1.401(a)(9)-6, Q&A-14(a)(4), includes an exception for increases that result from a plan amendment. In several rulings, the IRS ruled that this exception applies to a plan amendment implementing a temporary lump sum window feature, provided certain requirements are met. See PLRs 201228045, 201228051, 201422028, 201422029, 201422030, 201422031, and 201424031. Accordingly, prior to this Notice, participants in pay status could be provided the opportunity to elect a lump sum option.

The IRS Notice

The Notice states that the IRS intends to amend the required minimum distribution regulations ("MRD") under Internal Revenue Code section 401(a)(9) to provide that "qualified defined benefit plans generally are not permitted to replace any [annuity payment] currently being paid with a lump sum payment or other accelerated form of distribution." Specifically, the Notice states that "the IRS intend to propose amendments to section 1.401(a)(9)-6, Q&A-14(a) to provide that the types of permitted benefit increases described in that paragraph include only those that increase the ongoing annuity payments, and do not include those that accelerate the annuity payments [emphasis added]." However, the Notice suggests that it may amend Reg. section 1.401(a)(9)-6, Q&A-13, as well, which is the provision that allows changes to distributions upon plan termination. As a result, the Notice is not entirely clear whether the IRS might change the regulations to limit a plan sponsor's ability to offer a lump sum cashout for annuitants in pay status at the time of plan termination, but we do not anticipate any changes and will seek clarification in the pending regulations.

As a number of plan sponsors have been actively pursuing de-risking strategies this year, the effective date of the guidance is of particular importance. This guidance is effective July 9, 2015, but with limited exceptions if certain activities were underway at the time of the Notice (called Pre-Notice Acceleration). Specifically, a lump sum window for retirees is still permissible (and will not raise a plan qualification concern under Code section 401(a)(9)) if:

- the amendment was adopted or authorized by an entity with authority to amend the plan prior to July 9, 2015,
- with respect to which a private letter ruling or determination letter was issued (not submitted) by the IRS prior to July 9, 2015,
- with respect to which a written communication to affected plan participants stating an explicit and definite intent to implement the "derisking" program was received by those participants prior to July 9, 2015, or
- the amendment was adopted pursuant to an agreement between the plan sponsor and a union representative entered into and binding prior to July 9, 2015.

The Notice also expressly provides that any private letter ruling or determination letter issued by the Service or Chief Counsel will now generally include a caveat expressing no opinion as to the federal tax consequences of a lump sum risk-transferring program. But the IRS/Chief Counsel may still provide a determination that any Pre-Notice Acceleration satisfies the MRD requirements.

Lastly, the Notice expressly states that it does not provide any guidance on the tax consequences of a lump sum risk-transferring program under the various other sections of the Code – including 401(a)(4) (nondiscrimination rules), 411 (non-forfeiture), 415 (benefit limitations), 417 (spousal protections), and 436 (benefit restrictions).

Observations

Any company planning to amend its qualified defined benefit plan to provide for a temporary lump sum benefit will now have to limit eligibility for the lump sum option to participants who have not commenced distributions. Although the Notice provides MRD relief for situations where an entity has authorized such a window benefit as of July 9, 2015 (Pre-Notice Acceleration) – it is important to highlight that there are a number of Code provisions that need to be carefully considered in implementing lump sum windows.

Additional issues may surface when the proposed regulations are actually issued, so stay tuned.

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