Employee Benefits Corner

IRS Ends Lump Sum Windows for Individuals in Pay Status

*By Elizabeth Thomas Dold and David N. Levine**

On July 9, 2015, the IRS issued Notice 2015-49, which prohibits the use of lump sum payments to replace lifetime income being received by retirees under defined benefit pension plans, effective in large part as of such date. This lump sum window approach—which has been increasing in popularity over the last several years following a line of private letter rulings that expressly sanctioned this approach (often referred to as the Ford/GM rulings)—has been a method favored by plan sponsors to manage the ever-increasing costs of maintaining a defined benefit plan. Under this so called de-risking strategy, the plan sponsor would amend its plan to allow a participant to elect a lump sum payment that was not otherwise available under the plan terms for a specific period of time. Now this window approach will be limited to individuals not already in pay status (*e.g.,* deferred vested participants), which still has value but will no longer provide a solution for addressing pension liability for retirees in pay status.

This guidance is driven in large measure by policy concerns (and strong lobbying efforts) to protect retirees' lifetime benefits for a secure financial future. This results in keeping the investment and longevity risks on the plan sponsor. A brief summary of the de-risking strategies is set forth below, followed by a summary of the IRS guidance, and action steps for plan sponsors.

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De-Risking

There are a number of methods in play today that focus on ways to manage the risks associated with maintaining a defined benefit plan. These risks include:

- asset volatility and investment risks,
- increased retiree longevity (and pending mortality table changes),
- changes in accounting and funding rules,
- impact of plan liability on Company financials/stock price, and
- increased PBGC premiums and communication costs for inactive participants.

Some of the more popular "de-risking" strategies include: (1) liability-driven investing, (2) annuitizing accrued benefits (which can be costly, but completely shifts the liability risk to a third party), (3) "annuity buy-in" where the insurer and plan sponsor share the risks, and (4) lump sum windows, which involve

cashing out pensioners altogether, effectively shifting the investment and longevity risks to them.

The IRS guidance is focused on this last method, where the liability shifts entirely to the retiree. One significant area of uncertainty with this de-risking method has been whether a lump sum option could be offered to participants in pay status. Reg. §1.401(a)(9)-6, Q&A-1(a) states that once annuity payments begin, they cannot be changed and must be non-increasing. However, there are exceptions to this general prohibition. As relevant here, the Regulations include an exception for increases that result from a plan amendment. In a recent line of private letter rulings, the IRS ruled that this exception applies to a plan amendment implementing a temporary lump sum window feature, provided certain requirements are met.[1] Accordingly, prior to this Notice, participants in pay status could be provided the opportunity to elect a lump sum option.

If you fall outside of these limited exceptions, limit your lump sum window to individuals not in pay status (e.g., deferred vested participants), and stay tuned for the proposed Treasury Regulations that will reflect these changes.

The IRS Guidance

Effected Changes

The guidance is in the form of an IRS Notice that summarizes the changes that are going to be made to the Treasury Regulations. The Notice provides an overview of the minimum required distribution (MRD) regulations under Code Sec. 401(a)(9), and then outlines anticipated amendments to these regulations to reflect their intent that the exception for a plan amendment is limited to only those that increase the ongoing annuity payments, and does not include an amendment that accelerates the annuity payments. Specifically, the Notice states that the IRS intends to amend the MRD regulations 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." The Notice further states that the Treasury and "the IRS intend to propose amendments to section 1.401(a)(9)-6, Q&A-14(a)(4) 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]." The Notice also suggests that it may amend Reg. §1.401(a)(9)-6, Q&A-13, as well, which is the provision that permits changes to distributions upon plan termination pursuant to Q&A-13(b), but that said, we do not anticipated any changes to Q&A-13(b).

Effective Date

The effective date of the proposed change is critical for plan sponsors that have been engaged or are contemplating offering a lump sum window. Typically, changes in Treasury Regulations are made prospective—after a notice and comment period. However, the Notice plays an important role in justifying the retroactive nature of the pending changes to comply with Code Sec. 7805(b).

This guidance is effective July 9, 2015, unless the plan sponsor meets the requirements for a Pre-Notice Acceleration. Under this Pre-Notice Acceleration, the amendment specifically providing for implementation of a lump sum risk-transferring program must meet *one* of the following requirements prior to July 9, 2015:

- Such amendment was adopted or specifically authorized by a board, committee or similar body with authority to amend the plan.
- With respect to which a private letter ruling or determination letter was issued by the IRS. (Therefore, if the plan sponsor received its own private letter ruling or a determination letter that covered the amendment that was dated prior to July 9, 2015, this Notice has no application.)
- With respect to which a written communication to affected plan participants stating an explicit and definite intent to implement the "de-risking" program was received by those participants.
- Such amendment was adopted pursuant to an agreement between the plan sponsor and a union representative (with which the plan sponsor has entered into a collective bargaining agreement) specifically authorizing implementation of such a program that was entered into and binding.

Impact of the Guidance

After the effective date, a lump sum window that is extended to retirees in pay status will raise plan qualification issues. However, we do not anticipate any change for a

lump sum offered as part of a plan termination proceeding before the PBGC.

Any private letter ruling or determination letter issued by the IRS 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. However, the IRS or Chief Counsel may still provide a determination that any Pre-Notice Acceleration satisfies these MRD requirements.

Next Steps

This is the first published guidance that can (and must) be relied upon regarding the application of the Code rules on lump sum windows. The issue addressed in the Notice focuses on the scope of the eligibility provisions for the window, and should be followed in order to maintain the tax-favored status of the plan. Importantly, the Notice was quick to point out that it does not provide any guidance with respect to the federal tax consequences of a lump sum risk-transferring program under the following Code sections (or any other section of the Code except for Code Sec. 401(a)(9)):

- Code Sec. 401(a)(4)—this is the IRS nondiscrimination rules
- Code Sec. 411—this is the IRS non-forfeiture and anti-cutback protections
- Code Sec. 415—this is the IRS benefit limits
- Code Sec. 417—this is the IRS spousal protections
- Code Sec. 436—this is the IRS benefit restrictions based on the plan's funding levels

Therefore, if you are in the process of providing a lump sum option that extends to individuals in pay status, we recommend a file memo to show that you reviewed Notice 2015-49 and that you fit within one of the four exceptions listed above as of July 9, 2015, or that you otherwise meet one of the long-standing exceptions under Reg. §1.401(a)(9)-6, Q&A-13(b) (*e.g.,* plan termination), which we do not anticipate will change.

If you fall outside of these limited exceptions, limit your lump sum window to individuals not in pay status (*e.g.,* deferred vested participants), and stay tuned for the proposed Treasury Regulations that will reflect these changes.

And in all events, based on the numerous policy and compliance concerns in this area, give careful consideration to the various Code and ERISA restrictions that apply with this type of plan amendment, and be sure to document compliance with the various rules.

ENDNOTES

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1 *See* LTR 201228045 (Apr. 19, 2012), LTR 201228051 (Apr. 19, 2012), LTR 201422028 (Mar. 7, 2014), LTR 201422029 (Mar. 6, 2014), LTR 201422030 (Mar. 5, 2014), LTR 201422031 (Mar. 5, 2014) and LTR 201424031 (Mar. 21, 2014).

