It's Curtains For Some Lump Sum Programs

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On July 9, the Internal Revenue Service released Notice 2015-49 to announce it intends to prohibit retirees who are receiving annuity payments from a defined benefit pension plan from electing a lump sum in lieu of the annuity. The IRS will prohibit these elections by amending the Treasury regulations governing required minimum distributions. The notice reverses the IRS's position in a series of private letter rulings that allowed plan sponsors to offer retirees who had already commenced lifetime annuity payments the opportunity to cash out their remaining benefits in one lump sum payment during a limited “window period.” Plan sponsors can continue to offer a lump sum opportunity to terminated vested participants who are not yet in pay status, but the notice highlights the increased government scrutiny that lump sum window programs are attracting.

Background

The practice of offering lump sum cashouts has become increasingly popular among defined benefit plan sponsors looking to limit their liabilities for defined benefit plans. While many plan sponsors that offer lump sum windows limit eligibility for these programs to those participants who have not yet commenced benefits, some plan sponsors have also made these window programs available to retirees in pay status.

For those plan sponsors that offer lump sum cashouts to retirees in pay status, there has always been some concern that the practice violates the Internal Revenue Code’s required minimum distribution rules, which provide that once a participant or beneficiary begins receiving lifetime annuity payments, his or her monthly payment amount may not increase and his or her payment period may not be modified except in specific, limited circumstances. One key exception applies to a plan amendment that provides for the payment of increased benefits. Between 2012 and 2014, the IRS issued a series of private letter rulings that concluded that a retiree’s election to cash out the remainder of a lifetime annuity is permissible under this exception if the lump sum cashout option was offered pursuant to a plan amendment and was only available during a limited window period.
Notice 2015-49

In Notice 2015-49, the IRS explained that the required minimum distribution regulations are intended to prohibit most changes to a retiree’s annuity payments, including changes that might accelerate ongoing annuity payments. While the IRS acknowledged that under the current regulations, a pension plan may offer a limited lump sum cashout window to those retirees already receiving monthly annuity payments, it has concluded that this practice undermines the general intent of the regulations. Thus, the IRS and the Treasury Department intend to amend the regulations so that the only types of permitted benefit increases will be those that increase ongoing annuity payments without accelerating the payments.

The planned amendments will be effective as of the date of the notice, July 9, 2015, except for certain limited window programs that were already underway, including:

- Programs adopted or authorized by a board, committee or similar body with plan amendment authority before July 9, 2015;
- Programs with respect to which a private letter ruling or determination letter was issued before July 9, 2015;
- Programs communicated in writing to plan participants before July 9, 2015; or
- Programs adopted pursuant to an agreement between a plan sponsor and an employee representative of a collective bargaining unit before July 9, 2015.

Impact

Notice 2015-49 only impacts lump sum cashouts offered to participants already in pay status and does not affect the ability of plan sponsors to offer lump sum cashouts to terminated vested participants. However, the notice was issued amid government concerns that most retirees lack the financial understanding to effectively make a decision during a short window period regarding a lump sum payment of their pension benefits. The U.S. Department of Labor, for example, has expressed concern that participants electing lump sum cashouts lose the benefit of the Employee Retirement Income Security Act’s fiduciary protections and Pension Benefit Guaranty Corp. insurance. Earlier this year, the U.S. Government Accountability Office studied participant disclosures provided in connection with lump sum cashouts and concluded that all lacked at least one key piece of information participants would need to make a fully informed decision.

The latest IRS guidance is another reminder that these types of programs may be subject to increased scrutiny and that there are a number of other tax and fiduciary considerations plan sponsors should consider in designing them. The notice, and the change in position prohibiting lump sum offers to retirees who are receiving annuities, may also increase the demand for pension derisking through group annuity buyout transactions with an insurer.

—By Carol A. Weiser, Adam B. Cohen and Brenna M. Clark, Sutherland Asbill & Brennan LLP

Carol Weiser and Adam Cohen are partners in Sutherland’s Washington, D.C., office. Cohen is also an adjunct professor at Georgetown University Law Center.

Brenna Clark is an associate in Atlanta.

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