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COMPLIANCE ADVISORY

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IRS issues final rules for defined benefit plans regarding partial annuity distribution options

On September 8, 2016, the Internal Revenue Service (IRS) issued final regulations providing guidance that permits defined benefit plans, including cash balance plans, to simplify the calculation for certain optional forms of payment that are paid partly in the form of an annuity and partly in a single sum or other accelerated form of payment.

These regulations affect participants, beneficiaries, plan sponsors and administrators of defined benefit pension plans.

Background

The Internal Revenue Code (IRC) requires that the present value of any optional form of payment in a defined benefit plan cannot be less than the present value of the accrued benefit using a specific interest rate ("applicable interest rate") and mortality table ("applicable mortality table") required by the IRS. However, the IRC provides an exception to the minimum present value requirement. This exception applies to the amount of distribution paid in the form of an annual benefit, such as an annuity, that does not decrease during the life of the participant.

When a defined benefit plan offers a single-sum payment or other form of accelerated distribution as an optional form of payment in addition to the Qualified Joint and Survivor Annuity (QJSA), participants may have been reluctant to elect annuity payments to insure against unexpected longevity and instead have elected a single sum or other accelerated form of payment in order to maximize liquidity. However, participants who elect a single sum payment may face the challenge of outliving their retirement savings.

The IRS believes that many participants should have the opportunity to elect to receive a portion of their retirement benefits in an annuity (which provides financial protection against unexpected longevity) while receiving accelerated payments (e.g., single sum) for the remainder of their benefits to provide increased liquidity during retirement.

The IRS issued proposed rules in 2012 to simplify the treatment of certain optional forms of payment that are paid partly as an annuity and partly in a more accelerated form.

The IRS has recently issued regulations that finalize the proposed rules.

Bifurcation of accrued benefits

The final rules provide guidance under which a participant's accrued benefit can be split, or bifurcated, so that the minimum present value requirements apply only to the portion of the participant's accrued benefit that is paid in an accelerated form. The final rules provide two approaches to bifurcating the accrued benefit.

Explicit plan-specified rule

Under this rule, a plan may explicitly divide the accrued benefit so that the minimum present value requirement applies to a specific portion of the participant's accrued benefit as if that portion were the participant's entire accrued benefit. For example, a plan may provide that a single-sum distribution may be determined as a specific percentage of the

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participant's accrued benefit. A plan is also permitted to provide a single-sum payment of the accrued benefit attributable to employee contributions.

The remaining portion of the participant's accrued benefit (the participant's entire accrued benefit less the portion of the accrued benefit paid as a single sum) can be paid in another form of payment available under the plan.

Alternative rule

Under the alternative rule, the portion of the participant's accrued benefit, expressed in the plan's normal form of benefit and commencing at normal retirement age (or at the current date, if later) that is not paid in a single-sum payment, must not be less than the excess of:

- The participant's total accrued benefit expressed in the normal form of benefit; over
- The annuity payable in that form that is actuarially equivalent to the single-sum payment, determined using the applicable interest rate and applicable mortality table.

Thus, the portion of the participant's accrued benefit paid in a specific single-sum amount is implicitly determined as the actuarial equivalent of that single-sum amount.

Rules of operation

The final regulations also provide rules of operation that apply to one or both of the approaches described above pertaining to the division of benefits. The regulations provide that if a participant selects different payment options for two separate portions of the accrued benefit, then the two different payment options are treated as separate optional forms of payment, even if these options have the same annuity starting date. Thus, if one of those separate optional forms of benefit is exempt from the present value requirement, the plan must apply the present value applicable interest rate and applicable mortality table to the other optional form of benefit.

In addition, the explicit plan-specified rule must be used if a:

- Plan has been amended to eliminate an optional form of benefit, but retains the optional form for benefits accrued as of the amendment date; or
- Single-sum payment is available to settle a participant's entire accrued benefit and the plan permits a portion of the benefit to be paid as a lump sum.

If a plan provides for an early retirement benefit, a retirement-type subsidy, an optional form of benefit, or an ancillary benefit that applies only to a portion of the participant's accrued benefit, and the plan provides for an accelerated form of payment that settles some but not all of the participant's accrued benefit, the plan must specify which portion of the accrued benefit is settled by that distribution.

For example, if a plan has one set of early retirement factors that apply to an accrued benefit as of December 31, 2005, but a different set of factors that apply to benefits accrued after that date, and the plan provides for a single-sum payment that settles only a portion of a participant's accrued benefit, the plan must specify which portion of a participant's accrued benefit is settled by that distribution, in order to determine which early retirement factors apply to the remaining portion of the accrued benefit.

Anti-cutback relief

For plans that use the applicable interest rate and applicable mortality tables to calculate the amount of a payment that is made to settle a portion of a participant’s accrued benefit, the rules provide limited anti-cutback relief for plan years beginning before January 1, 2017. The rules allow plans to determine benefits using a bifurcation method prospectively without applying the minimum present value interest rate and mortality table to a participant’s entire accrued benefit provided the plan is amended on or before December 31, 2017.

Effective date

These regulations apply to distributions with annuity starting dates in plan years beginning on or after January 1, 2017. In addition, a taxpayer can elect to apply these regulations to earlier periods.

Next steps

Plan sponsors should carefully read the information contained in this newsletter. Sponsors should discuss the impact of this guidance on their plans with their enrolled actuary and their plan counsel.

Plan sponsors do not have to provide a partial annuity option. However, plan sponsors that elect to provide this payment option will need to amend their plan document to incorporate this plan design.

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