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Proposed IRS Regulations on Partial Lump Sum Pensions Require Comparison With Plans' Benefit Calculation Methods

February 21, 2012

Under some defined benefit plans, participants receive a portion of the benefit as an annuity and a portion as a lump sum. Sponsors of such plans should review the method used for calculating these benefits, particularly annuity benefits, to determine whether the combined value of both portions meets the minimum present value requirements for lump sums. Recent proposed IRS regulations include an interpretation of current law that may differ from the way some plans have been administered.

On February 2, 2012, the Internal Revenue Service (IRS) issued proposed regulations addressing the minimum present value requirements under Internal Revenue Code (Code) section 417(e) for defined benefit pension plans under which participants receive divided payments, typically a lump sum together with an annuity. If a participant can receive both a lump sum and an annuity, these proposed regulations aim to simplify and encourage the participant's choice of annuity benefits.

Notably, the preamble summary of current law concludes both parts of a divided pension benefit are treated as a single benefit subject to the same minimum present value requirements as lump sums. The proposal would create a limited exception, which becomes available only after the regulations take effect. If a plan satisfies the limited exception, the minimum present value requirements for lump sums would not apply to annuity benefits.

At this time, because of the proposal's key conclusion that both parts of a divided pension benefit are subject to minimum present value requirements, defined benefit plans offering divided benefits should be reviewed and compared with this interpretation of current law.

Background

Under Code section 417(e) and Reg. § 1.417(e)–1(d)(1), the present value of any accrued benefit and the amount of any distribution, including a single sum, must not be less than the amount calculated using the applicable interest rate and applicable mortality table specified under Code section 417(e)(3). The present value of any optional form of benefit cannot be less than the present value of the accrued benefit determined in accordance with these regulations. A limited exception to these minimum present value requirements is at Reg. § 1.417(e)–1(d)(6) for distributions paid in the form of an annual benefit that either does not decrease during the life of the participant, *e.g.*, a standard form of annuity benefit, or that decreases because of the death of the survivor annuitant or because of the cessation or reduction of Social Security supplements or qualified disability benefits. Note that a Social Security level income option, where the amount of a pension benefit is reduced to reflect the commencement of Social Security benefits, is not the same as a Social Security supplement and the exception does not apply to this form of payment.

The preamble to the proposed regulations states a partial lump sum and an annuity are viewed as a single "distribution," which decreases after the lump sum is paid but is not covered by any of the exceptions provided under Reg. § 1.417(e)–(1)(d)(6). Thus, both the lump sum and annuity portions of the distribution are subject to the present value requirements of Code section 417(e)(3). The proposal would create an exception for certain plan designs if the plan includes specific language that treats the separate portions of the divided benefit as two different distribution options for purposes of Code section 417(e)(3) and if certain other requirements are met. To qualify for this proposed exception, however, plan amendments would be required and those amendments would be subject to the anti-cutback rule of Code section 411(d)(6). Under that rule, the amount of each portion of a distribution after the amendment cannot be less than the amount that would have been payable under the provisions in effect before the amendment.

Consequences of IRS Interpretation of Current Regulations

Many defined benefit plans allow participants to receive both a lump sum and an annuity. The following are examples:

- A plan that provides a benefit based on a traditional pension formula through a specified date and a cash balance formula thereafter, with each portion determined separately; participants may separately elect optional forms of payment with respect to each portion of the benefit; a lump sum option is available only with respect to the cash balance portion
- A plan that permits participants to elect a partial lump sum payment, *e.g.*, a lump sum with a value up to a specified dollar amount or percentage of the benefit, and an annuity for the remaining portion
- A contributory defined benefit plan that allows participants to elect a lump sum equal to the employee contributions accumulated with interest, with the remainder of the benefit paid as an annuity
- A cash balance plan that provides grandfathered participants with a benefit equal to the greater of the traditional final pay formula in effect before the cash balance conversion or the benefit provided from the cash balance account; the lump sum option is limited to the cash balance account; a residual annuity is provided if the traditional final pay formula has a greater value

In some cases, the amount of the normal form of residual annuity payable at normal retirement age may be calculated using Code section 417(e) assumptions, but different assumptions are used to determine an optional form of annuity (*e.g.*, 10-year certain or survivor annuity) and/or an annuity payable at an earlier age. If different assumptions are used, reductions may be based on plan factors that are less generous for participants than Code section 417(e) requires.

For example, consider a plan that pays a lump sum of up to $50,000 and the remaining amount as an annuity. The plan calculates an optional 10-year certain and life annuity optional form for a 65-year-old participant as an amount equal to 94.7 percent of the straight life annuity. Assume that a participant has an accrued benefit of $1,000 (monthly straight life annuity), and that the single sum value of this benefit using Code section 417(e) assumptions is $156,150. If the participant elects a lump sum of $50,000 and receives the balance as a 10-year certain and life annuity, the plan might calculate the annuity as follows: $1,000 x ($156,150 - $50,000) / ($156,150 x 94.7%) = $643.77 per month.

The Code section 417(e) value of the $643.77 10-year certain annuity is only about $103,750, which results in a total payment value of $153,750 ($103,750 + $50,000). This total is less than the minimum required value of $156,150. In this case, the 10-year certain annuity payment would need to increase by about 2.3 percent, to $658.65 per month, to comply with the Code section 417(e) requirements.

Next Steps

Sponsors of defined benefit plans that offer partial lump sum payments should review whether annuity benefits are calculated in accordance with the IRS interpretation in the proposed regulations. The proposal seeks comments, and a public hearing is scheduled for June 1, 2012. It is expected that comments will include questions on the IRS interpretation of current law as expressed in the proposed regulations.