



WRMarketplace

An AALU Washington Report

The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by *Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone*. *WRMarketplace* #17-03 was written by Greenberg Traurig Associate Michelle Kauppila.

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the *Essential Wisdom Series*, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation’s most advanced life insurance professionals.

TOPIC: At Last - IRS Enhances Defined Benefit Plans.

MARKET TREND: Given longer life expectancies, defined benefit (“DB”) plan participants may want to hedge against outliving their retirement savings by electing an annuity payout, but instead have been forced to accept a lump sum because of the lack of flexibility in the IRS rules. These new rules change all of that.

SYNOPSIS: The IRS issued final regulations that enhance DB plans by allowing them to offer participants the option to select distributions partly in an annuity form and partly in a single lump sum. These regulations allow plans to bifurcate the accrued benefit and apply the present value requirement of Internal Revenue Code (“Code”) §417(e)(3) only to the portion of accrued benefits that are payable in a single sum and use regular plan factors for the portion payable in the annuity. This is a huge benefit, as it offers DB participants the ability to both receive a lump sum and an annuity - the best of both worlds.

TAKE AWAYS: With these new rules, advisors should offer to review all existing DB plans and advise on the formation of new ones. Employers also should prepare to educate their participants about the enhancement to their DB plans. Retirement plan providers and advisors should be prepared to work with employer-clients, their actuaries, and legal counsel to determine if any plan amendments are needed to reflect any plan design changes or to comply with the final regulations.

MAJOR REFERENCES: Treasury Regulation §1.417(e)-1(d)(7) (as amended by Treasury Decision 9783, 09/09/2016).

Last fall, the IRS issued final regulations under Code §417(e)(3) addressing the application of the minimum present value requirements to certain distributions of a participant's benefit from a DB plan. The final regulations permit plans to simplify the treatment of certain optional forms of benefit that are paid partly in the form of an annuity and partly in a more accelerated form of payment (such as a single sum distribution). Before these regulations, the IRS position was that both portions of a distribution option -- an annuity and a single sum or accelerated payment -- were subject to the minimum present value requirements of Code §417(e)(3). The latest final regulations provide that instead, a participant's benefit can be bifurcated so that the minimum present value requirements of Code §417(e)(3) apply only to the portion of the participant's benefit that is paid in the lump sum. The final regulations apply to distributions with annuity starting dates on or after January 1, 2017 but can be applied to earlier periods.

REASONS FOR THE NEW REGULATIONS

The IRS stated in the preambles to the proposed and final regulations that it was amending the Code §417(e)(3) regulations to facilitate the payment of pension benefits partly in annuity form and partly in a lump sum distribution. The IRS noted that many participants choose lump sum distributions when a DB plan offers the choice of a lump sum or an annuity form of payment. Because of the reluctance of participants to elect lifetime annuity payments over a lump sum, such participants are not insuring against unexpected longevity. The IRS believes that participants will be better served if they are offered the option to receive a portion of their pension benefits in an annuity and a lump sum that provides some liquidity.

The regulations are meant to make it simpler for plans to offer this optional form of benefit that is a combination approach.

CHANGES MADE BY THE FINAL REGULATIONS

The big change here is that the final regulations specifically state that the present value requirements of Code §417(e)(3) apply only to a portion of a participant's accrued benefit; that portion which represents a lump sum.

Generally Applicable Present Value Requirement. Before issuance of the regulations, the IRS view was that the present value requirements apply to the entire benefit in the case where a benefit is distributed in a combination of an annuity and a single sum (or accelerated distribution). The general rule of the Code §417(e)(3) present value requirements provides that 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 the applicable mortality table. The general rule does not apply to a distribution paid in the form of an annual benefit that (1) does not decrease during the life of the participant (or spouse in the case of a qualified pre-retirement survivor annuity) or (2) decreases during the participant's life merely because of the death of the survivor annuitant or the cessation or reduction of Social Security supplements or qualified disability benefits.

Application of Present Value Requirement to Distributions of a Portion of Participant's Accrued Benefit. Under the new regulations, a participant's accrued benefit may be bifurcated into separate components for purposes of applying the present value requirements. The regulations provide two methods for bifurcating plan benefits:

1. **Explicit Plan-Specified Bifurcation:** A plan is permitted to provide that the present value requirements apply to a specified portion of a participant's accrued benefit as if the specified portion is the participant's entire accrued benefit. For example, the plan may provide that a distribution in the form of a lump sum payment will be made to settle a specified percentage of the participant's accrued benefit or that a distribution in the form of a lump sum payment will be made to settle the accrued benefit derived from employee contributions.

In both examples, the distribution must satisfy the Code §417(e)(3) present value requirements with respect to the specified portion of the accrued benefit. The remaining portion of the accrued benefit (the participant's total accrued benefit less the portion of the accrued benefit paid in a lump sum payment) can be paid in any other form of payment available under the plan.

For example, Participant A has an accrued benefit of \$1,000 per month payable as a straight life annuity at normal retirement age. Participant A can, alternatively, elect a single sum payment of \$168,500 (based on the applicable interest and mortality rates under Code §417(e)) or a 100% joint and survivor annuity of \$850 per month. Participant A elects to receive 25% of the accrued benefit in a single sum payment and the remaining 75% of the accrued benefit as a 100% joint and survivor annuity. Based on this election, Participant A will receive a single sum distribution of \$42,125 (equal to 25% of \$168,500) and a 100% joint and survivor annuity of \$637.50 (equal to 75% of \$850). Participant A's monthly benefit of \$637.50 is determined by applying the plan's actuarial factors to the remaining portion of the accrued benefit of \$850 per month payable as a straight life annuity at normal retirement age. The joint and survivor annuity benefit is not subject to the present value requirements of Code §417(e)(3) because it is treated as a separate form of benefit. Before the final regulations, the joint and survivor annuity benefit would be subject to the present value requirements and likely could not be calculated as described above.

2. Distribution of a Specified Amount: A plan that provides for a distribution of a lump sum payment that is not described in (1) above will satisfy the Code §417(e)(3) present value requirements if the distribution of the remaining portion of the participant's accrued benefit, expressed in the normal form of benefit under the plan and commencing at normal retirement age (or current date, if later), equals no less than the excess of (1) the participant's total accrued benefit expressed in the normal form; over (2) the annuity payable in the normal form that is actuarially equivalent to the lump sum payment determined using the applicable interest rate and applicable mortality table.

For example, Participant B has an accrued benefit of \$1,500 per month payable as a straight life annuity commencing at the normal retirement age of 65. The Plan permits participants to elect a lump sum distribution equal to the participant's employee contributions accumulated with interest. Participant B has \$32,000 of accumulated employee contributions and interest. The lump sum payment in this plan is based on the total amount of B's employee contributions and not in reference to a specified portion of B's accrued benefit. Accordingly, the rules of paragraph 1 do not apply and, instead, this paragraph 2 applies.

Participant B retires at age 60 and elects to receive the \$32,000 lump sum payment and the remainder as a 10-year certain and life annuity. The Plan provides for an early retirement reduction factor of 75% for retirement at age 60 and a 98% actuarial adjustment for the 10-year certain and life annuity form of payment. Participant B's benefit commencing at age 60 in the 10-year certain and life annuity form of payment would be \$1,102.50 per month (equal to $\$1,500 \times 75\% \times 98\%$). The amount of B's annuity payments may not be less than the excess of (1) B's total accrued benefit, over (2) the annuity that is actuarially equivalent to the lump sum payment (determined using the applicable interest and mortality rates of Code §417(e)(3)), both expressed in the normal form of payment commencing at normal retirement age. The actuarial equivalent of the \$32,000 lump sum expressed as an annuity commencing at the normal retirement age of 65 is \$261.21. Thus, the portion of B's accrued benefit payable as a straight life annuity at normal retirement age must be at least \$1,238.79 per month ($\$1,500$ minus $\$261.21$). Applying the early retirement and optional form factors to this remaining portion, the annuity benefit payable to B in the form of a 10-year certain and life annuity beginning at age 60 is \$910.51 (equal to $\$1,238.79 \times 75\% \times 98\%$).

Plan Document Considerations. The final regulations specify that plans are required to use explicit bifurcation language in the following cases: (1) when a plan is amended to eliminate an optional form of benefit but retains the optional form of benefit for benefits accrued as of the amendment date, the plan must provide for explicit bifurcation of the accrued benefit as of the amendment date, and (2) when a plan provides that a single sum distribution is available to settle a participant's entire accrued benefit, the

plan must provide for explicit bifurcation of the accrued benefit in order for the plan to also provide that a participant can elect for a portion of the accrued benefit to be paid in a lump sum. In addition, a plan that 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 a participant's accrued benefit, and the plan provides for a distribution that settles some, but not all, of the participant's accrued benefit, then the plan must clearly specify which portion of the total accrued benefit is settled by that distribution.

The regulations provide for limited relief from the Code §411(d)(6) anti-cutback rule for plans that, before January 1, 2017, used the Code §417(e)(3) interest rate and mortality factors to calculate distributions that would not have been required to use these factors under the final regulations. With this relief, these plans can be amended to remove the Code §417(e)(3) interest rate and mortality factors for distributions occurring on or after the amendment date and, instead, apply the plan factors, even if applying the plan factors will result in a lower benefit amount than would have been calculated using the §417(e)(3) factors. The anti-cutback relief will apply if the plan is amended on or before December 31, 2017.

TAKE AWAYS

With these new rules, advisors should offer to review all existing DB plans and advise on the formation of new ones. Employers also should prepare to educate their participants about the enhancement to their DB plans. Retirement plan providers and advisors should be prepared to work with employer-clients, their actuaries, and legal counsel to determine if any plan amendments are needed to reflect any plan design changes or to comply with the final regulations.

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

