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IRS Announcement May Allow Lump Sum Window for Retirees

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Pension plan sponsors may have a new tool available to use in de-risking their pension plans – paying lump sums to retirees currently in payment status. As with some other de-risking initiatives, a retiree lump sum window could accomplish the reduction in PBGC headcount premiums as well as reduce the size of the plan liability and therefore reduce the risk to the organization.

Through the release of IRS Notice 2019-18 on March 6, 2019, the IRS officially announced that there will be no amendments to the minimum distribution regulations under IRC 401(a)(9) to address the retiree lump sum window concerns raised under Notice 2015-49. In addition, the IRS says that until further guidance is issued, they will not claim that a plan amendment providing for a retiree lump sum window program causes the plan to violate minimum distribution regulations. However, they will continue to evaluate whether such an amendment would cause concerns in regards to other sections of the IRS Code, namely those sections dealing with non-discrimination, vesting, benefit limits, optional forms of payment, and benefit restriction rules.

While IRS Notice 2019-18 does not make the legality of retiree lump sum windows perfectly clear, and the IRS has stated that it will "continue to study the issue of retiree lump sum windows," plan sponsors interested in possibly utilizing this de-risking technique should discuss the approach with their ERISA counsel and actuary to get a better understanding not only of the legalities, but the advantages and disadvantages associated with the approach. Some of these are listed below.

Advantages and Disadvantages of a Retiree Lump Sum Window

Advantages

- PBGC premium reduction
  - Plan sponsors will save money annually for each retiree that takes a lump sum.
  - Premiums are based on participant counts and depending on the funded status of the plan, plan sponsors could save between $80 and $600 per person each year.
- May provide positive balance sheet impact
  - In the current interest rate environment, there are many plans where lump sums may be less expensive than current accounting liabilities.
  - End of year funded status may improve as a result of paying out lump sums.
- PBGC funded status may improve in the current interest rate environment
  - Variable Rate premiums could be reduced.
  - 4010 filing requirements may no longer be required.
- One step towards full plan termination
  - Lump sums to retirees would reduce the size of the plan and take the plan sponsor one step closer to full plan termination.
- Reduced administrative expenses
  - Fewer 1099s will need to be distributed.
  - Payment processing fees will decrease.
- Reduction in headcount may lead to exemption from certain compliance requirements:
  - Control groups below 500 participants are exempt from at-risk provisions of the Internal Revenue Code.
  - PBGC 4010 filing requirements are eliminated if the headcount of the control group falls below 500.
  - A plan audit is no longer required if plan size reduces to less than 100 participants.

Disadvantages

- Additional pension expense and funding requirements
  - The lump sum window could trigger a one-time additional pension expense in the year lump sums are paid. The amount of expense will depend on the amount of lump sums paid as well as the balance sheet position at the end of the fiscal year.
- – A retiree lump sum window may lower AFTAP funding percentage and lead to increased minimum funding requirements.

- Increase in volatility
  - Retirees are the most stable group of participants in terms of liability.
  - Removing all or a portion of retirees will make the plan's liability more unstable and can make it harder for plan sponsors to plan or budget.
- Plan termination will be more costly
  - Retirees have the least per person cost in an annuity purchase.
  - Annuity providers will charge a higher premium when being offered a plan with a relatively small group of retirees.
  - Many annuity providers will also choose not to bid on plans that have previously offered retirees lump sums.
- Adverse selection
  - Retirees who opt to take the lump sum are more likely to be in poor health, and more likely to die before their actuarial life expectancy. By taking a lump sum today, they are being paid for future benefits that they might not otherwise survive to receive and therefore the plan could be overpaying this liability.
  - Retirees left in the plan are typically healthier and have a longer payment stream, making the remaining group a more expensive population to fund and later insure.

Another Option

Plan sponsors do not have to offer lump sums to their entire retiree population. This approach allows the plan sponsor to benefit from the advantages described above but also avoids the potential disadvantages. The retiree group can be carefully selected to maximize the results of the window.

Final Thought

Clearly there is a lot to consider and each plan and plan sponsor is different. Therefore it is highly recommended that plan sponsors review their plan with their actuary and ERISA counsel to determine if offering lump sums to retirees is an ideal strategy.

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