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ERISA Advisory

IRS Moves to Increase (Slightly) the Cost of Pension De-Risking

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"Pension de-risking" – a set of techniques for transferring a pension plan's financial risks from employers to insurance companies and participants – has been a notable, and not entirely uncontroversial, trend since Ford Motor Company employed it to settle $3.4 billion of pension obligations during 2012 and 2013. The impetus is apprehension that superficially well-funded defined benefit plans may become onerous burdens, primarily owing to rapid and unpredictable increases in pensioners' life spans. Other concerns are investment volatility (not a new phenomenon, of course) and steadily rising Pensions Benefit Guaranty Corporation (PBGC) insurance premiums. De-risking alleviates these worries by transforming uncertain future benefit streams into single, fixed payments.

In a typical de-risking transaction, the employer amends its plan to offer participants who are not in active employment a one-time option to take lump sum distributions in satisfaction of their accrued benefits. The offer sometimes includes those who have already started receiving their pensions, though concern about adverse selection makes that less than a universal practice. Participants who accept lump sums can roll them over into individual retirement accounts to avoid immediate taxation. The plan then purchases insurance company annuities (either individual contracts or a group annuity) to provide benefits that were not cashed out.

The current low interest rate environment makes these transactions expensive. By law, the interest rates used to convert pension entitlements into lump sums are tied to yields on high-grade corporate bonds, and the mandated mortality table reflects recent longevity increases. Annuity purchases from insurance companies are yet more costly at the present time. Nonetheless, many plan sponsors have concluded that the gains from de-risking more than offset the costs.

De-risking has, inevitably, drawn criticism. A particularly strenuous objection is that elderly pensioners may be tempted to take lump sum cashouts that they will be unable to manage prudently. A counter-argument is that the opportunity to switch from an annuity to a lump sum is beneficial in many cases. Investment growth can mitigate inflation's erosion of the value of fixed annuities. Pensioners whose health has deteriorated since retirement can receive a payout based on standard mortality tables, however short their real life expectancy. And low interest rates lead to larger lump sums than the historical norm.

The IRS has now taken a stand in this controversy. Notice 2015-49, released on July 9, announced that the regulations interpreting the minimum distribution requirements (section 401(a)(9) of the Internal Revenue Code) will be amended to bar participants who are receiving annuities from converting them into lump sums. The new restriction will not apply to de-risking programs that, before July 9, 2015, satisfied any one of these conditions:

- An amendment providing for the conversion was "adopted (or specifically authorized by a board, committee, or similar body with authority to amend the plan)"
- The IRS issued a favorable private letter ruling on the transaction
- Affected participants received written communications "stating an explicit and definite intent to implement the lump sum risk-transferring program"
- The conversion option was required by a binding collective bargaining agreement

One point that the Notice leaves unclear is whether the prohibition will apply to participants who are receiving pensions but have not yet reached their section 401(a)(9) required beginning date (generally, April 1 of the year following the attainment of age 70½). We also do not know whether it will extend to terminating plans. Some plans, particularly those with only a few pensioners, offer them lump sum elections on termination in order to ease the burden of buying a small number of annuity contracts.

Strictly speaking, Notice 2015-49 has no legal effect. It is no more than a statement of an intention to propose a regulation, which will then be subject to the notice and comment requirements of the Administrative Procedure Act. In practice, even if plan sponsors assume that the IRS will hold to the announced effective date and refrain from offering lump sums to pay-status participants, de-risking transactions will still be able to go forward. Annuity purchases are usually their largest element, and lump sums can still be made available to participants who have terminated employment but are not yet receiving pensions. As already noted, many de-risking programs do not, in any event, allow current pensioners to convert to lump sums. The upshot of the IRS's new position will be some increase in cost, but rarely a prohibitive one.

For such limited impact, the IRS seems to be straining its interpretive powers. As the Notice observes, the objective of the minimum distribution rules is "to ensure that a distribution of the employee's benefit will not be unduly tax-deferred." To that end, the regulations limit the circumstances in which a pension paid in annuity form may increase over time. It is not permissible to start benefits at a very low level, then increase them steadily, as that pattern of distribution would delay the receipt of much of the pension's value until near the end of the participant's lifetime or beyond. (Before section 401(a)(9), a somewhat popular form of distribution for wealthy participants was a lump sum paid at age 80, which satisfied the prior version of the minimum distribution requirements. The tax collector's reasons for disliking that option should be obvious.)

A lump sum window does not, however, delay distributions at all. It accelerates payments that would otherwise have been made later. The Notice presents no argument at all that the practice that it bans leads to greater tax deferral than section 401(a)(9) already allows.

Recognizing this fact, the IRS has in the past routinely issued private letter rulings approving lump sum conversions for participants in pay status. Those rulings undermine the Notice's claim that "the intent" of the section 401(a)(9) regulations is to "prohibit, in most cases, changes to the annuity payment period for ongoing annuity payments from a defined benefit plan, including changes accelerating (or providing an option to accelerate) ongoing annuity payments." And if that had been the (unexpressed) intent of the regulations, that intent would have been inconsistent with the statute.

While not a fatal blow in itself, Notice 2015-49 may be a prelude to other governmental actions against de-risking. The severest critics of de-risking object to offering lump sum elections to participants who are not yet in pay status and to the loss of PBGC insurance when annuity purchases transfer liabilities from plans to insurance companies. Whether the agencies that regulate pension plans can or will do anything about these alleged problems is uncertain. The IRS Notice may turn out to be the first shot in a long campaign.