One Minute Memo®

IRS Provides Guidance on Lump Sum Window Periods for Defined Benefit Plans

This spring, Ford Motor Company and General Motors made headlines by announcing that they intended to reduce pension liability by offering a "window opportunity" to permit retirees and terminated vested participants to elect a cash out of their pension benefits. On July 16, 2012, the Internal Revenue Service released two private letter rulings (PLRs) (both dated April 19, 2012) approving proposed amendments to defined benefit plans to offer such a voluntary lump sum option to retirees who elect that option within a window period. These rulings provide a road map for other defined benefit plan sponsors to offer a similar cash-out option for their participants.

In PLR 201228051, the IRS approved a 30-60 day window period for participants receiving annuity benefit payments ("in-pay retirees") to make a one-time election to receive the remainder of their benefits in the form of a lump sum. In PLR 201228045, the IRS approved a 60-90 day window period for a broader group of individuals, including in-pay retirees as well as terminated vested participants and beneficiaries of deceased participants, to make one-time elections to receive lump sum payments.

Compliance with Distribution Rules. The key issue addressed by the IRS was whether the cash-out of pension annuities currently in pay status would violate the "required minimum distribution" (RMD) rules in Section 401(a)(9) of the Internal Revenue Code. Generally, the RMD rules provide that once a participant or beneficiary begins receiving lifetime annuity payments, payments must be non-increasing and the payment period may not be modified except in specific circumstances, such as due to a plan amendment providing for the payment of increased benefits. In both PLRs, the IRS recognized that the addition of the proposed lump sum option would constitute a payment of increased benefits which would necessarily shorten the payment period for in-pay retirees and beneficiaries. The IRS concluded, however, that such a change to permit a cash-out of the remainder of the annuity was permissible under the RMD rules because the lump sump option was being offered pursuant to a plan amendment and only during a limited window period.

Additional Legal Requirements. In addition to limiting the availability of the lump sum option to retirees to a confined window period, the IRS noted several other requirements for these options:

- A lump sum window period may only be added to a plan that is at least 80% funded and may not cause the plan's funding level to drop below 80% if all eligible individuals elect the lump sum option.
- The amount of the lump sum payment must equal at least the actuarial present value of the remainder of a participant's or beneficiary's benefit under the plan.
- In addition to being offered the immediate lump sum option, an in-pay retiree (or other participant) must also be offered an immediate qualified joint and survivor annuity (QJSA) and qualified optional survivor annuity (QOSA). All lump sum elections are subject to the Internal Revenue Code's spousal consent rules.
- Any portion of a lump sum payment which constitutes an RMD may not be rolled over to an IRA or other eligible retirement plan. However, the remainder of the lump sum payment would be eligible for rollover.
- Plans using an approved plan-specific mortality table different from the IRS' standard "applicable mortality table" may continue to use the approved mortality table to calculate lump sum payments during the window period as long as the table remains sufficiently predictive (as determined by the plan's actuary).

Also, in both PLRs, the plan sponsor proposed to offer financial consulting through independent and/or “highly qualified and reputable” financial advisors to each individual eligible for a lump sum. It is unclear, however, whether the IRS views this as a necessary precondition to a valid lump sum window period.

Considerations for Plan Sponsors. Driven by concerns about the impact of fluctuations in interest rates used to value pension liabilities on the funding status of defined benefit plans, many plan sponsors are exploring options for shedding as much of those liabilities as possible. Now that the types of lump sum window periods offered by Ford and General Motors have been approved by the IRS, plan sponsors may take greater comfort when considering such options for their own plans. Note, however, PLRs are only controlling with respect to the taxpayers requesting them. In light of the foregoing, and the complex legal rules related to lump sum payments, plan sponsors should consult with legal counsel and actuaries to determine the appropriateness of a lump sum window period.

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