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Defined Benefit Plans

IRS Private Letter Rulings Add Fuel to Fire On Lump-Sum Offers, De-Risking Debate

Five recent Internal Revenue Service private letter rulings allowing defined benefit plans to offer lump-sum benefit distributions to participants already receiving benefits are likely to encourage more employers to jump on the de-risking bandwagon, especially at a time when many employers are expressing interest in decreasing the impact of plan risks on their balance sheets.

The IRS issued four PLRs on May 30 (106 PBD, 6/3/14; 41 BPR 1174, 6/10/14) and another on June 13 (see related article in this issue) (116 PBD, 6/17/14) holding that such offers during a limited window do not violate the tax code's minimum distribution requirements in tax code Section 401(a)(9).

The PLRs removed a possible cloud over the legality of making lump-sum offers to participants in pay status, Rosina B. Barker, a partner at Ivins, Phillips & Barker Chartered in Washington, told Bloomberg BNA on June 16.

Until those rulings were issued, many plan sponsors were hesitant to make these lump-sum offers due to the IRS's silence on the matter since it had put out two PLRs in 2012 permitting this practice, Barker said.

Some plan sponsors already believed that this type of de-risking is permissible under IRS regulations, an interpretation that the letter rulings confirm, she said.

''Based on these PLRs and on several IRS regulations, many taxpayers will feel they can safely take the position that lump-sum offers are permitted to participants in pay status in a de-risking context,'' she said.

However, the new PLRs aren't likely to quell the debate over whether these offers are a good thing for participants.

''The rulings, which are limited to Section 401(a)(9) of the tax code, are a bit hard to understand given how as a policy matter, the Obama administration has favored lifetime income options over lump sums,'' Norman P. Stein, a professor of law at Drexel University who specializes in pensions and employee benefits law, told Bloomberg BNA on June 18. ''These rulings are giving partial license to employers to offer lump sums to the most vulnerable part of the participant population,'' he said.

The new PLRs, though they are binding only on the taxpayer that requested them and cannot be used or cited as precedent, will get the attention of other plan sponsors interested in de-risking pension liability, Barker and Stein agreed.

More Such PLRs Unlikely. Barker said plan sponsors shouldn't necessarily expect more rulings along the lines of the recent PLRs.

''We understand informally that the IRS may soon stop issuing these private letter rulings,'' she said. ''But many plan sponsors will be interested in making lump-sum offers to participants in pay status with or without a private letter ruling, based on the opinion of their counsel that these offers are permitted by IRS regulation,'' she said.

The new rulings are ''substantially similar'' to the 2012 PLRs, with several noteworthy differences, according to a Mercer GRIST report issued June 16. The report said that the new PLRs ''explicitly state that IRS is not opining on whether the lump sum calculation method satisfies the minimum present value requirements of Code Section 417(e).'' In addition, it said, the PLRs ''appear to confirm that an offer of financial counseling is not a prerequisite for receiving a favorable ruling,'' since three of the five sponsors didn't mention financial counseling or participant communications.

De-Risking Surveys. Sponsors' requests for PLRs are not surprising given the climate of increased interest in pension de-risking. In survey results released June 9 by the LIMRA Secure Retirement Institute, 80 percent of surveyed defined benefit plan sponsors expressed interest in ''pension risk transfer products,'' LIMRA said.

Prior surveys have also reflected growing interest in de-risking. In a 2013 survey, 40 percent of senior finance executives said they would ''seriously consider'' transferring their companies' plan risk to a third-party insurer in 2014 and 2015 (148 PBD, 8/1/13; 40 BPR 1886, 8/6/13).

Interest in pension risk transfer was greatest among sponsors with frozen plans, Alison Salka, senior vice president and director of the LIMRA Secure Retirement Institute, told Bloomberg BNA on June 16, discussing the results of her organization's survey. Of the plan sponsors that said they were ''very'' interested in these products, 53 percent had a partially frozen plan and 23 percent a completely frozen plan. Nineteen percent of those interested didn't have frozen plans, she said, adding that ''it is not surprising that those with frozen plans would express more interest in pension plan risk transfer solutions.''

Of the one in five plan sponsors that didn't express interest in pension risk transfers, 30 percent said it was because they don't know enough about the subject, more than any other factor that was cited. Twenty-two percent said the high cost of purchasing annuities was

holding them back. "There is a misconception that the cost of transferring the risk through an annuity would be prohibitive but recent analysis by Mercer found that it was slightly cheaper for a plan sponsor to purchase a buyout for the retiree portion of its plan than it was to keep it in-house," Salka said in a news release announcing the survey results. "We expect the growing impact of DB plans on balance sheets is going to drive more CFOs and others in finance to learn about and consider pension risk transfers in the future," she said.

"A majority of plans, when they freeze their defined benefit plans, are committed to adding value to their defined contribution" plans, Salka told Bloomberg BNA, noting that 48 percent of survey respondents who had frozen their plans had also added to or increased the employer match in their defined contribution plans and 12 percent had enhanced the retirement benefit in other ways.

Consultant-Driven Actions. Karen Friedman, executive vice president and policy director of the Pension Rights Center, told Bloomberg BNA on June 16 that she found it revealing that although 80 percent of plan sponsors in the LIMRA survey expressed interest in pension risk transfer products, many were unfamiliar or only slightly familiar with those products.

"Consultants are selling plan sponsors on the idea of de-risking, even if many of the sponsors don't know what it is," she said. These kinds of surveys are done in a broad brush and plan sponsors, if given the idea, would likely be receptive to the notion of getting plan liabilities off of their books, she said.

"There's an antiseptic quality to these kinds of surveys that overlooks the interests of participants and retirees," she said.

Friedman said that the survey results and continued conferences on this subject are geared toward encouraging more plan sponsors to seek to de-risk. Friedman said her organization is opposed to retirees in pay status being given the option of a lump sum because many will feel tempted to take it due to family pressures, concerns about the plan's viability or misinformation about the ability of the Pension Benefit Guaranty Corporation to pay the plan's benefits if the plan becomes insolvent.

On the other hand, she said, if plans want to de-risk, there are ways to do it through in-plan strategies. Examples of these strategies include matching the risk and duration of the plan's investments with liabilities and offering in-plan annuities, she said. "Doing an annuity within the plan is generally more protective than shipping off the liability to an insurance company or giving lump sums to retirees," she said.

Partial License. Discussing the private letter rulings, Stein said he doesn't think the tax code is clear on whether lump-sum offers to participants already in pay status are permitted, and that given the uncertainty, he is surprised that the IRS has been willing to provide rulings.

Stein, who also advises the Pension Rights Center, said offering lump sums to people already in pay status is disturbing. The plan sponsors that offer lump sums to people already in pay status are banking on many of them making an ill-advised financial choice, he said.

"Let's be honest: No employer is offering lump sums to retirees because the employer suddenly wants to give a financial windfall to retirees who know that they will not live out their life expectancy, generally the only people who should take a lump sum," he said.

He said plan sponsors give a new lump-sum choice to retirees because they know that a fair number of those who will lose money by taking the lump sum will take it anyway and that those bad choices will save the employer money. "It is pretty cynical, actually," he said.

The new rulings will not necessarily hasten the demise of the defined benefit plan system, which has been under stress for some time, Stein said. But he said, it's a variation on the same theme as dropping a defined benefit plan for a Section 401(k) plan: Sponsors of defined benefit plans are trying to shed costs by making employees fend for themselves.

"I think this is a pretty troubling phenomenon," he said.

By Joe Lustig

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The LIMRA survey results are at http://www.limra.com/Posts/PR/News_Releases/LIMRA_Secure_Retirement_Institute__Plan_Sponsors_Express_Interest_in_Pension_Risk_Transfer_Products.aspx.

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