Final 417(e) Regulations Add New Requirements and Offer Design Flexibility

A Practical Guidance® Article by R. Randall Tracht, Claire E. Bouffard, and Mark J. Simons, Morgan Lewis & Bockius LP

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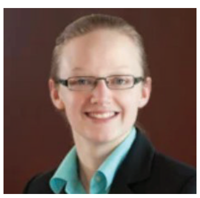

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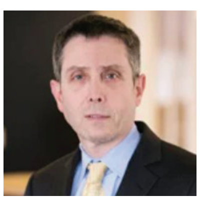

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The U.S. Internal Revenue Service (IRS) recently issued final regulations concerning "minimum present value requirements" for tax-qualified defined benefit plans (DB plans). There are three primary changes for sponsors of DB plans to note and consider in their plan design.

Expansion of Anti-Cutback Relief for Changes to Code Section 417(e) Interest Rate

The anti-cutback rules under Internal Revenue Code (Code) Section 411(d)(6) prohibit DB plan sponsors from reducing benefits once a participant has earned them. Thus, in many instances plan sponsors can only reduce benefits prospectively, and may need to implement rules and safeguards to ensure the prospective reduction does not inadvertently reach back and reduce already earned benefits.

DB plan sponsors are mandatorily required to use the interest and mortality assumptions specified in Code Section 417(e)(3) when calculating lump sums. Section 417(e) requires that plans select a "lookback month" and "stability period" to determine which interest rate applies during what period.

The "stability period" is the time a particular interest rate is in effect (year, quarter, or month) and the "lookback month" is the first, second, third, fourth, or fifth month prior to the start of a stability period that the plan looks at in order to determine which interest rate should apply during that stability period. While plans are required to use the Section 417(e)(3) interest rate for lump sums and Social Security Level Income Option (SSLIO), among others, plans also sometimes use this rate for optional purposes, such as conversion to other annuity optional forms.

To avoid violating the anti-cutback restrictions, plan sponsors are limited in their ability to change the lookback month and stability period (i.e., because the new lookback month/stability period might result in a smaller lump sum at different points as both rates fluctuate in unpredictable ways). The IRS previously provided some relief allowing plans to change the lookback month and stability period for the Code Section 417(e) interest rate by giving participants the better of the benefit calculated under the existing rate and under the new rate for annuity starting dates during the one-year period following the effective date of the amendment (or adoption, if later).

However, such relief has traditionally been allowed by the IRS only for certain limited purposes classified by the IRS as "mandatory" Code Section 417(e)(3) uses, such as the calculation of lump sums. If the Code Section 417(e) interest rate is used for any "optional" purposes, plans are required to give participants the greater benefit using each set of rates for all time, which could be more costly and complicated administratively.

The final regulations now extend the anti-cutback relief to all optional uses of the Code Section 417(e) interest rate. This means it will be easier when DB plan sponsors want to change the interest rate benchmark that they use to calculate "optional" items such as (1) annuities provided by "cash balance" plan accounts, (2) early retirement reductions, (3) late retirement increases, (4) optional life annuity payment forms, (5) actuarial adjustments for "QDROs," and (6) the correction of administrative errors or application to "retroactive annuity starting dates."

The change will still trigger the requirement to provide the greater benefit using each set of rates, but this period will only last one year, rather than for the life of the plan, making changing the Code Section 417(e) interest rate much simpler.

Action Item: DB plan sponsors may want to review their menu of optional Code Section 417(e)(3) interest rate uses and discuss with their actuary and legal counsel the pros and cons of changing the related actuarial interest rates in light of the expanded anti-cutback relief. In particular, there may be opportunities to simplify and streamline benefit calculations by using the anti-cutback relief to eliminate legacy Code Section 417(e)(3) interest benchmarks that may have been preserved under the old rules. Amendments adopted now can take advantage of this relief.

Lump Sum Distributions of Employee After-Tax Contributions

For annuity starting dates on or after October 1, 2024, DB plans that (1) are funded in part by after-tax employee contributions and (2) offer a lump sum form of payment must ensure that lump sums are calculated without applying a "preretirement mortality assumption" to the portion of the benefit attributable to the employee contributions. This means that, as the lowest-cost solution, the lump sum must be bifurcated between the employee-funded and employer-funded portions when making the calculation.

Alternatively, to make things easier (but potentially more costly), the entire lump sum can be calculated without a preretirement mortality assumption. This is because a lump sum calculated without a preretirement mortality assumption will generally be larger and more valuable than a lump sum calculated with one.

In drafting federal pension laws, Congress consistently has given particular attention to the treatment of employee contributions (e.g., requirements that they not be forfeited, not use preretirement mortality assumptions in the conversion of the employee contributions to an annuity). In the final regulations under Code Section 417(e)(3), the IRS reverses its prior position that the preretirement mortality assumptions could be applied in converting the entire accrued benefit into a lump sum, citing concern that this could result in a forfeiture of employee contributions. However, the final regulations provide that calculations that are done consistently with prior IRS guidance (including applying preretirement mortality) for annuity starting dates prior to October 1, 2024 can continue and need not be recalculated.

The final regulations describe these requirements as applying to distributions that occur at or before normal retirement age and indicate that the minimum present value is based on an immediate annuity. The IRS indicates in the preamble that the application of mortality assumptions to payments made after normal retirement age is an issue that will be addressed under future regulations.

Action Item: Plan sponsors maintaining a DB plan with employee after-tax contributions should confer with their actuary and legal counsel to discuss the impact of the final regulations, the value of bifurcation versus the ease of aggregation, and any plan document changes possibly needed to reflect those issues.

Social Security Level Income Options

An SSLIO form of payment in a DB plan has historically been subject to certain actuarial valuation requirements described in Code Section 417(e)(3). An SSLIO is an annuity that pays more for the period before the annuitant reaches age 62 (before Social Security benefits are available) and pays less after age 62 to reflect that the participant is receiving Social Security benefits, with the intent that the participant has a "level" stream of retirement income. Since a portion of the participant's benefit must be accelerated to pay the increased benefits before age 62, the valuation rule is meant to ensure that the SSLIO form of payment has a minimum floor value calculated using the Code Section 417(e)(3) interest rate and mortality.

The final regulations relax the valuation requirement by allowing plans to apply the minimum floor rule only to the pre-62 portion of the annuity for annuity starting dates on and after October 1, 2024. If adopted, any change must be carefully implemented using a methodology that complies with the "anti-cutback" rules under Code Section 411(d)(6) and ensure that participants do not receive smaller benefits under the new rule than they would have under the old rule.

Action Item: Sponsors of a DB plan with an SSLIO should discuss with their actuary and legal counsel whether they could adopt the new rule in light of the anti-cutback issue and whether the related complications would be worth the related savings, if any. Generally speaking, fully "frozen" DB plans will not be eligible to adopt the rule due to the anti-cutback rules.

Related Content

Practice Notes

- Anti-cutback Rules for Qualified Retirement Plans (IRC § 411(d)(6))
- Qualified Retirement Plan Distribution Rules

Statutes & Regulations

- 89 Fed. Reg. 3552 (Jan. 19, 2024)
- I.R.C § 417
- Treas. Reg. 1.417(e)

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