Employee Benefits Corner

New IRS and Court Guidance Continue to Support "De-Risking" Strategies

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Plan sponsors have been focused on possible financial/benefit strategies to "de-risk" their defined benefit pension plans over the years. The focus on "de-risking" continues to arise as a result of a number of factors—increased asset volatility, increased retiree longevity, changes in accounting and funding rules, concerns about ongoing benefit liabilities and their potential impact on the value of the plan sponsor's securities, the general decline/freeze of defined benefit pension plans, increased PBGC premiums, and communication costs for inactive participants. This is true despite our current environment of low interest rates, which has the effect of increasing lump sum distribution payments and the cost of fixed income products.

There are a number of different "de-risking" strategies that have been used over the years, including (1) liability-driven investing, (2) annuitizing accrued benefits (which can be more costly, but completely shifts the liability risk to a third party), (3) "annuity buy-in" where an insurer and plan sponsor share financial risks, and (4) and retiree cashouts, which shifts the investment and longevity risks to the participants.

Five recent IRS private letter rulings, following the ground-breaking 2012 Ford and GM rulings, provide a clear signal from the IRS that the minimum distribution rules don't stand in the way of this technique. Below we describe these private letter rulings—LTR 201422028, 201422029, 201422030, 201422031 and 201424031 (dated March 7, 2014, March 6, 2014, March 5, 2014, March 5, 2014, and March 21, 2014 respectively), and focus on any differences from the Ford/GM rulings. We also take a look at the recent Verizon decision, where the federal district court again ruled in favor of Verizon and dismissed all claims, where Verizon purchased a group annuity product to satisfy the retiree pension obligations.

The Rulings

In the line of private letter rulings, beginning with LTR 201228045, the company proposed to amend its plan to offer a one-time lump sum option

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to former participants, including retirees in pay status. The ruling requested a determination that this feature does not violate the Code Sec. 401(a)(9) required minimum distribution rules for participants and beneficiaries in pay status. For defined benefit plans, these rules require that all payments (whether paid over an employee's life, joint lives, or a period certain) must be nonincreasing.[1] However, the regulations further explain, in Q&A-14(a), that the annuity payments may increase as a result of certain listed exceptions, which expressly include "[t]o pay increased benefits that result from a plan amendment."

Plan sponsors have been focused on possible financial/benefit strategies to "de-risk" their defined benefit pension plans over the years.

The IRS has repeatedly held that the one-time window did not violate the minimum required distribution requirements, and cited the legislative history of the provision, that these rules were designed to prevent lifetime accumulations which might escape income taxation altogether, which is not a concern here.[2] Specifically, the rulings hold that for individuals in pay status, the proposed amendment will result in a change in the annuity payment period. The annuity payment period will be changed in association with the payment of increased benefits as a result of the addition of the lump sum. Moreover, individuals who wish to change their current distribution will be considered to have a new annuity starting date as of the first date of the month in which their new benefit is payable. Therefore, the IRS ruled that because the ability to select a lump sum will only be available during a limited window, the increased benefit payments will result from the proposed plan amendment and, as such, are a permitted benefit increase under the regulations.

The key provisions of the Private Letter Rulings (which can only be relied on by the companies that received them) are outlined in Table 1. But remember that the rulings do not address the other legal and administrative concerns that should be considered as part of the lump-sum window, including: (1) nondiscrimination requirements under Code Sec. 401(a)(4) (including "benefits, rights, or features" testing), (2) anti-cutback provisions under Code Sec. 411(d)(6), (3) benefit limits under Code Sec. 415, (4) the QJSA/QOSA and spousal consent requirements under Code Sec. 417, (5) calculation of interest rates and mortality assumptions for lump sums in accordance with Code Sec. 417(e), (6) restrictions on lump sums depending on the plan's funding status in accordance with Code Sec. 436, and (7) various administrative hurdles, including participant communication, election packages, obtaining union approval, and reporting distributions.

Verizon Decision

Verizon used a de-risking strategy of transferring retiree liability to a group annuity provider outside of the plan. In the process, the plan spent $8.4 billion to purchase a group annuity contract which guaranteed the benefits of nearly 41,000 Verizon retirees, and removed this liability from its books. The latest federal district court decision, which comes on the heels of already two favorable decisions for plan sponsors considering a similar strategy—the first from December 2012 (Verizon I), denying a putative class action a motion for a restraining order on the annuity purchase, and the second from June 2013 (Verizon II), ruling that the retiree class plaintiffs did not state any ERISA causes of actions and dismissed the claims— the judge again ruled on April 11, 2014 (Verizon III) that the retiree class action claims were deficient, and rejected them in their entirety. This is another success story for de-risking.

Notably, the court rejected the ERISA fiduciary breach claims. The revised claim alleged that Verizon should have consulted with the retirees and kept the annuity as a Plan asset in order to maintain ERISA protections and the PBGC's benefit guarantees. In response, the court simply reiterated its prior ruling that Verizon was not acting as fiduciary when it amended the plan to direct the annuity purchase because "the disputed decisions involve Verizon's role as settlor, not Plan fiduciary."

The other fiduciary breach claims largely centered on the fact that the annuity premium paid exceeded the Plan's valuation of its liabilities by $1 billion, and thus violated ERISA (and the Plan's) exclusive benefit rule and did not represent a reasonable expense for administering the plan. The court continued to view this claim as "conclusory," and rejected it.

The claim that purchasing the annuity the day after the plan was amended to provide for it was a fiduciary breach was also rejected. The court focused on the fact that two months prior, Verizon retained an independent fiduciary to represent the interest of plan participants and satisfy ERISA fiduciary standards, including the "safest available annuity" requirement of DOL Interpretive Bulletin 95-1,

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TABLE 1.

	LTR 201228045 [Likely the Ford Ruling]	LTR 201228051 [Likely the General Motors Ruling]	LTR 201422028	LTR 201422029	LTR 201422030	LTR 201422031	LTR 201424031
The Plan	Traditional pension plan, with no lump sum offered. The Company explained that its pension benefit obligations to its defined benefits plans and the obligations reported on the Company's financial statements were disproportionately large, very sensitive to swings in interest rates, and skewed disproportionately towards retirees.	Traditional and cash balance plans, where the cash balance plan already offered a lump sum option as a distribution option.	Multiple employer defined benefit plan, offers lump sum withdrawal of only the participant's contributions under the plan. Plan sponsor represented that the pension obligations are disproportionately large and increasingly volatile, and sensitivity to swings in interest rates, which hinders the participant companies' ability to remain competitive in the industry.	Defined benefit plan, with lump sum option for non-CBA participants Plan sponsor represented that the volatility of the market and interest rates increased pension costs and made the company less competitive.	Defined benefit plans, which generally offer lump sum payments in only certain cases. The Company represented that its pension benefit obligations to its defined benefits plans and the obligations reported on the Company's financial statements were disproportionately large, very sensitive to swings in interest rates, and skewed disproportionately towards retirees.	Traditional and cash balance plans, where the cash balance plan already offered a lump sum option as a distribution option. The plan sponsor represented that various factors (including investment returns and sensitivity to shifts in interest rates and industry subject to global economic changes, the pension obligation have become increasing volatile, resulting in increased difficulty with cash flow forecasting and management.	Defined benefit plan, with a lump sum option beginning after their earliest commencement age. The plan sponsor represented that the pension obligations proposed particular risks, and the window would reduce administrative costs and limit pension financial and demographic risk exposure.
The Proposed Amendment	One-time offer of Lump Sum that represents the actuarial present value of their remaining benefits under the Plan at the time of the election.	One-time offer of Lump Sum that represents the actuarial present value of their remaining benefits under the Plan at the time of the election.	One-time offer of Lump Sum that represents the actuarial present value of their remaining benefits under the Plan at the time of the election.	One-time offer of Lump Sum that represents the actuarial present value of their remaining benefits under the Plan at the time of the election.	One-time offer of Lump Sum that represents the actuarial present value of their remaining benefits under the Plan at the time of the election.	One-time offer of Lump Sum that represents the actuarial present value of their remaining benefits under the Plan at the time of the election.	One-time offer of Lump Sum that represents the actuarial present value of their remaining benefits under the Plan at the time of the election.
Eligibility	(1) participants currently receiving benefit payments; (2) participants who have retired but have not begun receiving benefit payments; (3) terminated deferred vested participants; (4) beneficiaries who are receiving survivor benefits under the Plan or are eligible to receive survivor benefits; and (5) alternate payees under a qualified domestic relations order.	Only certain participants and beneficiaries in pay status.	Certain retired participants, alternate payees, and beneficiaries. Note that a subset of retirees, in objective and nondiscriminatory category, may be excluded due to administrative practicalities.	(1) participants currently receiving benefit payments; (2) participants who have retired but have not begun receiving benefit payments; (3) terminated deferred vested participants; (4) beneficiaries who are receiving survivor benefits under the Plan or are eligible to receive survivor benefits; and (5) alternate payees under a qualified domestic relations order. Note that a subset of retirees, in objective and nondiscriminatory category, may be excluded due to administrative practicalities.	(1) participants currently receiving benefit payments; (2) participants who have retired but have not begun receiving benefit payments; (3) beneficiaries who are receiving survivor benefits under the Plan or are eligible to receive survivor benefits; and (4) alternate payees under a qualified domestic relations order.	Certain retired participants, alternate payees, and beneficiaries who are receiving monthly benefits. Note that a subset of retirees, in objective and nondiscriminatory category, may be excluded due to administrative practicalities.	Retired or terminated participants currently receiving annuity payments, and beneficiaries who presently are receiving annuity payments. Note that a subset of retirees, in objective and nondiscriminatory category, may be excluded due to administrative practicalities.

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TABLE 1. (Continued)

	LTR 201228045 [Likely the Ford Ruling]	LTR 201228051 [Likely the General Motors Ruling]	LTR 201422028	LTR 201422029	LTR 201422030	LTR 201422031	LTR 201424031
Duration of the window	60–90 days	30–60 days	60–90 days	30–60 days	60–90 days	60–90 days	30–90 days
Annuity Options	QJSA and QOSA	QJSA and QOSA	QJSA and QOSA	QJSA and QOSA	QJSA and QOSA	QJSA and QOSA	QJSA and QOSA
Spousal Consent	Current and former spouse (at the time of the initial annuity starting date), if different.	Current and former spouse (at the time of the initial annuity starting date), if different.	Current and former spouse (at the time of the initial annuity starting date), if different.	Current and former spouse (at the time of the initial annuity starting date), if different.	Current and former spouse (at the time of the initial annuity starting date), if different.	Current and former spouse (at the time of the initial annuity starting date), if different.	Current and former spouse (at the time of the initial annuity starting date), if different.
Assistance offered in making the election	Yes, optional financial counseling from highly reputable financial advisor.	Yes, optional financial counseling provided by an independent financial advisor.	No, ruling silent.	No, ruling silent.	No, ruling silent.	No, ruling silent.	Yes, optional financial counseling provided by a qualified and reputable financial advisor.
Legal Issue Addressed	Code Sec. 401(a)(9)—required minimum distributions' prohibition against increasing payments.	Code Sec. 401(a)(9)—required minimum distributions' prohibition against increasing payments. Code Sec. 4974—50% excise tax on failure to take minimum required distributions is not triggered. Applicable mortality tables that can be used.	Code Sec. 401(a)(9)—required minimum distributions' prohibition against increasing payments.	Code Sec. 401(a)(9)—required minimum distributions' prohibition against increasing payments.	Code Sec. 401(a)(9)—required minimum distributions' prohibition against increasing payments.	Code Sec. 401(a)(9)—required minimum distributions' prohibition against increasing payments. Code Sec. 4974—50% excise tax on failure to take minimum required distributions is not triggered.	Code Sec. 401(a)(9)—required minimum distributions' prohibition against increasing payments.
Legal Issues Not Addressed	Code Secs. 411, 415, 417 and 436; Title I of ERISA	Code Secs. 401(a)(4), 411, 415, 417 and 436; Title I of ERISA	Code Secs. 401(a)(4), 411, 415, 417 and 436; Title I of ERISA	Code Secs. 401(a)(4), 411, 415, 417 and 436; Title I of ERISA	Code Secs. 401(a)(4), 411, 415, 417 and 436; Title I of ERISA	Code Secs. 401(a)(4), 411, 415, 417 and 436; Title I of ERISA	Code Secs. 401(a)(4), 411, 415, 417 and 436; Title I of ERISA

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and no challenge was made regarding the independent fiduciary's decision.

Lastly, in closing, the court stated:

> at bottom, plaintiffs are disagreeing with the rights of a settlor under ERISA, and such a disagreement must be addressed to Congress through requests for legislative changes to ERISA, not through litigation that complains of the decisions that ERISA empowers a plan sponsor as settlor to make.

Accordingly, the court's repeated rejection of the class plaintiffs' fiduciary and other challenges to Verizon's annuity purchase provides helpful support for use of this strategy as a way to decease a segment of plan liabilities. It also provides a model process to follow—including retention of an independent fiduciary and amending the plan to clearly direct the annuity purchase—for interested plan sponsors wanting to minimize the risk of a successful challenge. The next step for the plaintiff's class action is to appeal to the Fifth Circuit, which is anticipated.

Whether Congress, the IRS or the DOL will place any future restrictions on these types of de-risking strategies remains to be seen. Notably, the ERISA Advisory Council in 2013 looked at a variety of de-risking strategies and submitted a related report for the Secretary's review, which is expected to be published in the near term. So stay tuned!

ENDNOTES

1 Reg. §1.401(a)(9)-6, Q&A-1(a).

2 *See* 108 Cong. Rec. 18755, 18756 (1962).

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