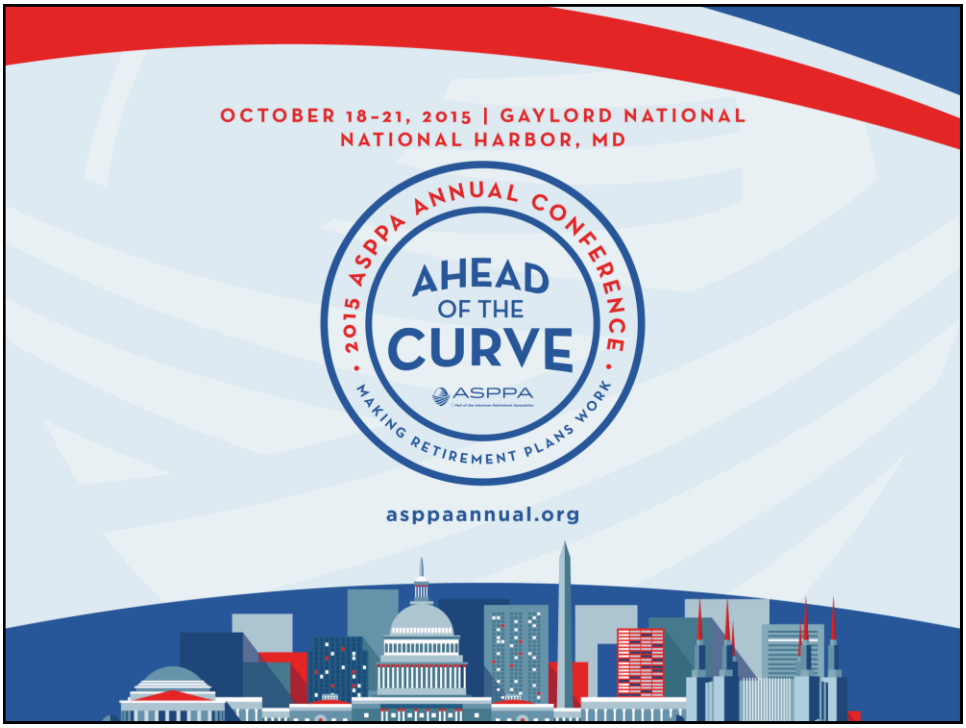

Workshop 63: Lump Sum Issues

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Overall Focus

- Traditional formula type (annuity defined)
  - What lump sum must be paid?
  - What lump sum can be paid?
- Lump sum based formula (CB or PEP)
  - Can the defined lump sum be paid?
  - Must more than the defined lump sum be paid?
  - What annuity must be provided?

Considerations

- Legal requirements
- Plan design impact
- Communication issues

LEGAL REQUIREMENTS

Legal Requirements

- Section 401(a)(4) restrictions
- Section 401(a)(9) requirements
- Section 411(a)(13)
- Section 415(b) maximum
- Section 417(a) notices and relative value disclosure
- Section 417(e)(3) minimum
- Section 436 restrictions

Section 401(a)(4)

- High-25 restrictions – plan must provide, in any year, only straight life annuity for Top-25 HCE or former HCE unless
  - After taking into account lump sum, assets at least 110% of CL (FT probably used),
  - Lump sum less than 1% value of CL, or
  - Less than $5,000
- On plan termination can show benefit is not discriminatory

Section 401(a)(9)

- Age 70 ½ commencement for 5% owner
- Annuity commences and then wants to change to lump sum on retirement
  - New ASD for 415 and 417
  - Meet 415 at original ASD with modification (using interest rates and mortality table at that date)

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Section 411(a)(13)

- Added by PPA ’06
- Concerns lump-sum based formulas
- Allows that certain requirements (including 417(e)) are not treated as failed to be met if the plan provides that the present value of the benefit is hypothetical account or current accumulated percentage of pay

Section 411(a)(13)

- For 2016 and later, regulations require that optional form of benefit be the actuarial equivalent (using reasonable assumptions) of the hypothetical account or accumulated percentage of pay

Section 415(b)

- AB limited to lesser of
  - 100% of Hi-3 compensation limit (with 10 YOS)
  - Dollar limit adjusted for retirement age before age 62 or after age 65, and for less than 10 YOP
- Adjustment of limit for form of benefit
- Assumptions for adjustment specified to some extent

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Section 415(b)

- Adjustment assumptions
  - For form adjustments if § 417(e) does not apply, and for age adjustments– Interest rate of 5% and 417(e) mortality table
  - For form adjustments if § 417(e) does apply –
    - Interest rate of 5.5% and 417(e) mortality table
    - 417(e) interest rate and 417(e) mortality table with factor of 1.05 (if not a small plan)
    - Plan actuarial equivalence definition

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Section 415(b)

- Requirement for multiple annuity starting dates – specific rules reserved

Section 417(a)

- Waiver of QJSA needed
- Relative value disclosure needed
  - Description of forms of benefit
  - Numerical comparison
    - Compare lump sum to value of QJSA
    - Compare QJSA to annuity equivalent of lump sum
    - Compare lump sum as % of value of QJSA
  - 417(e) assumption or other rate used to compute form of benefit

Section 417(e)(3)

- Existing regulations – Present value of AB and the amount (subject to 411(c)(3) and 415) of any distribution must not be less than amount determined using
  - Applicable interest rate (segment rates today) and
  - Applicable mortality table
- Not updated for 411(a)(13)

Section 436

- Restricts lump sums
  - If AFTAP less than 60% no lump sums payable (except under \$5,000)
  - If AFTAP less than 80%, but at least 60%, than lump sum that can be paid is lesser of
    - 50% of lump sum, or
    - Present value of maximum PBGC Guaranty (at age 65 is \$806,683 for 2015) using 417(e) rates
    - Remainder as annuity

PLAN DESIGN IMPACT

Plan Types

- Traditional DB – benefit defined as annuity benefit (perhaps with post-retirement adjustments such as COLA)
- Hybrid plan – lump-sum based definition of benefit (cash balance plan or pension equity plan)

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Traditional Design

- Annuity not at § 415 maximum
  - Generally, lump sum based on § 417(e) rates
  - However, cannot produce more than § 415 permits
- Annuity at § 415 maximum
  - Generally, lump sum based on least of 5.5%, plan rate for equivalence, or 417(e) factor times 1.05

Traditional Design

- Consider two benefits payable at age 65 - $210,000 and $190,000
- Using 11/2014 rates & 2015 mortality table
  - $210,000 PV= $2.8 million
  - $190,000 PV = $**2.54** million
- Using 5.5% & 2015 mortality table
  - $210,000 PV = $2.445 million
  - $190,000 PV = $2.21 million

Traditional Design

- Benefit of $210,000 – lump sum limited to $2.445 million by § 415 (application of parenthetical in regs.)
- Benefit of $190,000 – lump sum must be limited to $2.445 million to comply with § 415 (another application of parenthetical in regs.); when $2.54 million converted is $218,300
- Plan language needs to reflect this; consider benefit levels and interaction

Hybrid Design

- Want to pay lump sum of $2,400,000 at age 65
  - Plan design for owner is lump sum of $240,000 for each of first 10 years of participation
  - Converted at 65 using 5.5% gives $206,100
  - Appears no problem, however

Hybrid Design

- Can $2,400,000 be paid?
  - Suppose § 417(e) rates change to 5.25%, 5.5%, 6%
  - How is $2,400,000 converted if want annuity
  - If use § 417(e), then result is $207,500
  - If use 6%, then result is $214,700 and exceeds $210,000
  - Need to limit conversion rate (perhaps to 5.5%)

Hybrid Design

- Lump sum is $250,000 (10% of $250,000 pay for 10 years)
  - Conversion is 5.5% and applicable mortality
  - For 2015 this is $21,465
- What happens if 3.75% used to convert?
  - For 2015 this is $18,392
  - Suppose 3.75% is not reasonable and January 2015 rates apply (1.33%, 3.46%, 4.40%)
  - Must pay $255,468 (whipsaw)

Underfunded Plan

- AFTAP is 70%, benefit is $210,000, and lump sum in 2015 is $2.445 million, participant not in Top-25 HCEs
  - Can only pay $806,683; now what?
  - Plan must permit that either the remaining benefit is paid as annuity or deferred to later (subject to 411(a)(11) and 401(a)(9) rules)
  - Plan may provide option to delay remainder and take it as lump sum when no longer restricted (subject to 417(e) and 415 at each date)

Underfunded Plan

- How is remaining benefit determined?
  - Plan terms?
  - The $806,683 is considered using 8/2014 rates to be equivalent to $60,136
  - Leaves $210,000 minus $60,136 or $149,864 as an annuity (note disconnect with plan 417(e) rates)
  - Can defer post-65 (if increases under plan)
  - Better to have plan provide for annuity until can pay lump sum?

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Underfunded Plan

- Now consider that $210,000 is also the 100% of high-3 years average compensation
  - No actuarial increase for delay in payment is permitted
  - Cannot forfeit benefit
  - Only option is to pay the $149,864

Underfunded Plan

- Suppose participant is one of Top-25 HCEs
  - Now can only pay annuity (pursuant to probable plan terms)
  - Most plans (all?) are not specific as to what happens once plan is better funded
  - Defer payment until entire lump sum permitted, or start payment and provide lump sum of remaining payments when funding improved
  - Raises multiple annuity starting date issues

Underfunded Plan

- Be sure to look at how 110% after payment measured
  - MAP-21 or HATFA rates rather than other rates
  - May need to amend plan provisions

Communication Issues

- QJSA definition
- Underfunding

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QJSA Definition

- Must be at least 50% and not more than 100% of amount payable to participant
- Do not have to make a reduction, so can be subsidized with no § 415 problem (just do not make it normal form, but automatic optional form)
- However, what is goal?

QJSA Definition

- Maximize deduction – yes, a fully subsidized QJSA can help, but
- If pay lump sum on single life annuity, may well have surplus
- Relative value disclosure
  - Shows lump sum has lower value as compared to QJSA
  - Will there be consent?
  - Avoid issue (provide no subsidized QJSA)

Underfunded Plan

- Restrictions will apply
  - If due to § 436 then notice to participants comes into play (if title I plan)
  - However, communication to plan sponsor will have to come first
  - If due to Top-25, then no notice but may need to interpret options under plan

Underfunded Plan

- Options for Top-25 (assuming sponsor can continue to fund the plan)
  - Start annuity and pay lump sum later when funding improves
  - Defer any payment until can pay lump sum
  - Payout lump sum and establish escrow account
  - Can a plan amendment help?
- If cannot continue to fund, terminate the plan

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Questions

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