IRS and Treasury Say No More Lump-sum Offers

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MarketWatch Blog by Alicia H. Munnell

Alicia H. Munnell is a columnist for ***MarketWatch*** and director of the Center for Retirement Research at Boston College.

Amended regulations will protect retirees from sacrificing lifetime benefits.

The Internal Revenue Service and the Treasury have done a wonderful thing. They announced last month that they intend to **amend regulations** in order to prohibit companies from "de-risking" their defined benefit plans by offering a lump-sum option for retirees already receiving benefits. In other words, defined benefit plans will not be able to replace any annuity currently being paid with a lump sum or any other accelerated payment. Many in Congress and the Administration, the Government Accountability Office (GAO), and organizations outside government such as the Pension Rights Center have expressed concern about turning streams of income back into lump sums. These regulations will end that procedure; they will also make the "de-risking" process more expensive for companies.

De-risking has become an attractive option to companies in the wake of more stringent funding standards and changes in the accounting treatment of pension plan obligations that increased balance-sheet and income-statement volatility. De-risking can be accomplished in many ways, including

shutting down a plan. Shutting down a plan, however, requires that it be fully funded and the cost of funding up is often too steep.

In 2012 a new form of de-risking emerged with initiatives by General Motors and Ford. Ford offered lump sums to a group of retirees and vested deferred workers. General Motors offered lump sums and then transferred the remaining liabilities to an insurance company. Two facts about the lump-sum offerings are interesting. First, they generally involved an age cap, because older retirees were thought to have a better sense of their mortality risk and, thus, would be more likely to opt for the lump sum if they expected to die soon. Second, about 30 percent of those offered a lump sum accepted the offer.

The greater the percentage accepting the lump sums, the cheaper is the transaction for the company. First, the Internal Revenue Code allows plans to use a higher interest rate in calculating the lump sum than is used by insurance companies in pricing annuities. Second, the Code allows companies to use less conservative mortality tables than those used by insurers. Third, the plan does not need to pay any fee for administration of payments to participants, regulatory compliance, or investment management. Finally, the plan does not need to pay a profit for the insurer.

What is good for the companies, however, is generally bad for the retirees. Retirees opting for a lump sum immediately lose the advantages of lifetime income and become responsible for their own investments. This shift might be fine for those with a serious illness about to die and for the wealthy with a substantial nest egg, but for most retirees it's a bad idea. They immediately take a loss in the sense that they cannot duplicate the income stream in the private market, because individual annuities are expensive – particularly for women, who tend to live longer. The individuals opting for lump sums also

will face investment fees – sometimes high – when operating on their own. And, if they don't immediately place their lump sum in an Individual Retirement Account, they will be taxed on the full amount in the year of receipt.

Under the best of circumstances, deciding whether to take a lump sum requires very careful consideration. But the **GAO study** published in January 2015 found that the lump-sum packages offered by companies routinely lacked key information, such as the formula used to calculate the lump sum.

So it is terrific that the IRS and the Treasury are amending the regulations in order to prohibit plans from offering lump sums in exchange for defined benefit annuities. Unfortunately, the new rules take effect only for companies de-risking after July 9, 2015. Since 2012, 35 additional companies – including the New York Times, the Washington Post, and Boeing – have offered lump sums. So a lot of retirees have already been hurt. But the new regulations will protect millions more.