Treasury and IRS Have Given a Green Light to Offering Retiree Pension Buy-Outs

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MarketWatch Blog by Alicia H. Munnell

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Transforming a stream of lifetime benefits into a lump sum undermines retirement security.

Recently, the **IRS walked back protections** that limited a company's ability to offer a lump-sum payout for the monthly benefit provided by its defined benefit pension plan. This strategy of offering lump sums allows companies to reduce their liabilities before purchasing a group annuity from an insurance company – a process known as "de-risking."

This de-risking strategy made the headlines in the United States in 2012 with an initiative by General Motors (GM). GM wanted to transfer its liability for retiree benefits to The Prudential Insurance Company of America. In order to reduce its liability before the transfer, GM offered 42,000 of its salaried retirees the option of accepting a lump sum.

The offer to un-annuitize – transform lifetime incomes into lump sums – is a step in the wrong direction. Retirees with ongoing monthly pension benefits are much more secure than those who have to decide how to allocate their retirement assets over an uncertain lifespan. Retirees with a pension will not outlive their benefits and they do not have to worry about the ups and downs of the stock market. Taking the lump sum is a really risky business; retirees end up paying high fees as well as facing volatile financial markets.

Policymakers viewed these buy-out offers as the most alarming aspect of the de-risking initiative. Yes, those who do not accept the buy-out will get their check from an insurance company rather than from the defined benefit plan, so their benefits are no longer insured by the Pension Benefit Guaranty Corporation (PBGC). But that risk has generally been viewed as tolerable. Transforming lifetime income streams into lump sums would leave most people less well off.

It has never been clear that offering buy-outs was permissible under the existing Required Minimum Distribution (RMD) regulations, which state that once distributions have commenced they can be changed only in line with exceptions enumerated in Treasury regulations. One such exception is a "benefit increase" whereby a beneficiary could convert the survivor portion of a joint-and-survivor annuity into a lump sum upon the employee's death. Though the regulations do not explicitly recognize a similar right to convert an annuity into a lump sum during the employee's life, the IRS issued private letter rulings treating buyouts as permissible under the Treasury exemption.

In 2015, the Treasury and IRS announced that they intended to amend the RMD regulations to specify that a "benefit increase" will include only a change that increased ongoing annuity payments, not one that simply accelerated annuity payments. In the wake of this announcement, the IRS did not explicitly prohibit lump-sum buy-outs, but included in any private letter ruling a caveat expressing no opinion as to the federal tax consequences of the lump-sum risk-transferring program.

In March 2019, the Treasury and the IRS notified taxpayers that they no longer intend to amend the RMD regulations. This guidance expressly supersedes the 2015 notice. Thus, companies now pretty much have a green light to proceed with buy-out offers as a part of their de-risking initiatives. Is there anyone who should take the lump sum? Only those with a serious illness who believe that they do not have much time left should even consider it. The trouble with counting on death, however, is its unpredictability; even sick people may live longer than they think. Moreover, given today's tumultuous markets, it is unlikely that even the sophisticated investor will be able to generate more income from their lump sum than their company pension. Retirees, beware!!