Defined Benefit Plan Participants Can Receive Lump Sum and Annuity Under New Rules

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Defined benefit plan participants will have greater flexibility in choosing how to receive their pension benefits under final regulations issued by the IRS (T.D. 9783 (https://www.gpo.gov/fdsys/pkg/FR-2016-09-09/pdf/2016-21393.pdf)). The regulations finalized proposed rules issued in 2012 that permit participants to elect to receive split benefits of monthly annuity payments together with a lump-sum payout without disqualifying the plan. The IRS believes plan participants are better served against the possibility that they will outlive their retirement benefits when they can choose to bifurcate their benefits between the two options.

The rules are designed to enable participants to receive a portion of the plan benefit as a stream of monthly payments while taking the remainder in a single, lump-sum cash payment. The regulations encourage these split options by changing the minimum present value requirements for defined benefit plan distributions to permit plans to simplify the treatment of certain optional forms of benefits that are paid partly in the form of an annuity and partly in a more accelerated form. Defined benefit plans are allowed to apply actuarial assumptions on interest rates and mortality benefits only to the portion of the distribution being paid as a lump sum. The partial annuity portion of the benefit is determined using the plan's regular conversion factors.

The final regulations adopt the proposed rules (REG-110980-10 (https://www.irs.gov/irb/2012-13_IRB/ar11.html)) with a few changes in response to comments. One change was to the approaches to bifurcating the benefits so the minimum present value requirements applied only to a portion of the accrued benefit. The proposed rules outlined three methods, which some commenters criticized as unclear. Under the final rules, there are two options.

Under the first option, a plan is permitted to bifurcate the accrued benefit so that the plan provides that the requirements of Regs. Sec. 1.417(e)–1(d) apply to a specified portion of a participant's accrued benefit as if that portion were the participant's entire accrued benefit. This rule does not impose any requirements on the distribution options for the remaining portion of the accrued benefit.

An alternative rule permits a plan that distributes a specified single-sum amount to a participant to be treated as satisfying the requirements under Regs. Sec. 1.417(e)–1(d) for that payment, provided the remaining portion of the participant's accrued benefit satisfies a minimum requirement. Under that minimum requirement, the portion of the participant's accrued benefit, expressed in the normal form of benefit under the plan and commencing at normal retirement age (or at the current date), must be no less than the excess of (1) the participant's total accrued benefit in that form over (2) the annuity payable in that form that is actuarially equivalent to the single-sum payment, determined using the applicable interest rate and the applicable mortality table.

The changes under these regulations apply to distributions with annuity starting dates in plan years beginning on or after Jan. 1, 2017, but taxpayers may apply the rules to earlier periods.

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