Deciding When to Retire
Legal Constraints

Age and Age Discrimination Generally

- What does retire mean?
- Code and ERISA prohibit an NRA later than the later of age 65 or the 5th anniversary of participation
  - DB plans often use the 5th anniversary rule, but DCs do not. Why?
- Full vesting at NRA; and generally the right to commence benefits at age 65
- The "rate of benefit accrual" cannot be reduced on account of age. EEOC has a similar rule.

2

Retirement under DC Plans
Working Past NRA

- Contributions and earnings both continue after NRA; investment strategy may change
- Death benefits (account balance) unaffected
- Some DC plans allow payouts in service, e.g., after NRA
- No required payouts to employees at 70 ½ (for non-owners)

3

Retirement under DC Plans
Receiving Benefits Before NRA

- DC plans typically allow lump sum payouts after termination of employment; mandatory rollover right
- 10% additional income tax pre-59 ½ for amounts paid out but not rolled over (does not apply to life annuities or payouts over life expectancy; +other exceptions)
- Former EEs have right to defer payment to 65 (if benefit over $5,000); most plans mandate commencement by NRA for former EEs
- No deferral past 70 ½ (this is mostly an IRA issue)
- Fiduciary issues discussed later

4

Retirement under **DB Plans**
Working Past NRA

Client is working after NRA (65) and thinks she is entitled to get her pension or at least get extra pension benefits. Is she right?

- Some DB plans allow in-service payouts at NRA
  - Cannot be earlier than age 62: phased retirement concept
- Accruals have to continue after NRA
- Some DB plans provide a minimum actuarial increase for working after NRA (Social Security benefits increase for late commencement is 8% annually)
- After NRA, the accrual rate does not go down, but the value of the additional annual accrual generally goes down.

5

Retirement under DB Plans
Working Past NRA

Example: Assume the client above is turning 65 and has 20 years of accrual credit. Plan only provides for accrual credit after 65.

- So one more year of accrual credit increases her pension by 5%; but if her age 65 accrual had been increased by interest (say 6% rate) and mortality risk (say 2%), then her age 65 pension (with no credit for the additional year) would have increased by 8%. So the value of the additional annual accrual is zero and she 'forfeits' 3% of her prior pension.
- This is allowed, but employers are required to notify employees of this (a kind of 'forfeiture'). (Called a suspension of benefits notice.) Did she get this notice and is it readable?

6

Retirement under DB Plans
Working Past NRA

- Death benefits are required to continue for married EEs (QJSA)
- Some plans provide increased benefits for death while working
- Sometimes an EE should accelerate retirement for mortal illness (and sometimes plans have rules to prevent this)

7

Retirement under DB Plans
Receiving Benefits Before NRA

- DB plans often allow pre-NRA immediate payouts only for termination of employment after an early retirement age
- Other vested EEs get actuarially reduced benefits and 'grow in' right; QPSA death benefit required
- A former EE has the right to defer payment to 65
- Exception for cashouts for benefits worth $5,000 or less
- 10% additional income tax pre-59 ½ (does not apply to life annuity payouts or amounts rolled over; +other exceptions)
- QJSA rules apply; some plans offer lump sum payouts; value protected for lump sums; generally a mistake to elect a lump sum (see handout)
- Early retirement may include a subsidy (example below)

8

Retirement under DB Plans
Actuarially Equivalent Benefits

- <u>Example of actuarial reduction (sometimes called a retirement "penalty"</u>: Assume your client is a 55-year old participant with a normal retirement benefit of $4,000 a month commencing at NRA (65). He wants you to sue because he is being penalized a lot if he chooses an immediate pension.
- The benefit commencing at 55 would be of equal actuarial value if it is reduced by 1) interest (the income stream at 55 will commence 10 years earlier), 2) change in life expectancy (a p's life expectancy is longer at 55 than at 65), and 3) pre-commencement mortality, i.e., the chance that the p will die before commencement (i.e., before 65) with no death benefit under the plan (excluding QPSA and other death benefits that are not part of the accrued benefit).

9

Retirement under DB Plans Receiving Benefits Before NRA

- Note that Social Security reduces benefits for early commencement by about 6.7% annually
- Note the inverse interest rate in DB plans in 1) above
  - higher interest rate=bigger reduction
  - lower interest rate=smaller reduction
- In DC plans, we think in terms of the account balance – a present value
- In DB plans, we think in terms of life annuities at NRA (a future income stream for life), not a present value
- It's confusing to try to shift back and forth, but important to understand DB economics

10

Retirement under DB Plans Receiving Benefits Before NRA

- Example of an early retirement subsidy: assume an actuarial reduction from age 65 to age 55 might be say a 60% reduction (it could be more – or less -- depending on the interest rate and mortality table used), so $4,000 monthly for life beginning at 65 would result in a $1,600 monthly actuarially equivalent annuity for life beginning at 55. Conversely, if that same life annuity at 65 has a present value at age 65 of say $40,000, but the life annuity payable at 65 is also payable in the event of early retirement at or after 55 (so the benefit is fully subsidized), then the present value at 55 would be $100,000 (under the same assumptions).

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Retirement under DB Plans Receiving Benefits Before NRA

- Thus, in this example, terminating employment just before age 55 would result in a loss of $60,000 in pension value
- Many DB plans provide partial subsidies for early retirement, for example, the early retirement 'penalty' might be 'only' 5% per year, not 8% per year
- Note that Social Security reduces benefits for early commencement by about 6.7% annually (but increases benefits for late commencement by 8% annually)

12

Hybrid DB Plans

- These include cash balance and pension equity plans
- Annual accruals under a cash balance plan include a ‘pay credit’ plus an interest credit. Example:
  - pay credit equals say 6% of pay, so the pay credit for a $50,000 salary employee is a $3,000
  - Interest credit depends on p’s prior balance and plan’s interest rate, e.g., a 5% interest credit on a $50,000 account balance results in a total balance of $55,500 (3,000+2500)
- At retirement, cash balance plans offer lump sums equal to account balance, or actuarially equivalent annuities (incl QJSA)

13

Hybrid DB Plans

- Another kind of hybrid are pension equity plans (PEP) which have serious legal compliance issues
  - It is illegal for the aggregate accrued benefit to decline, but this can occur if a PEP credits interest after termination of employment

14

Retirement under DB Plans Receiving Benefits Before NRA

- Retirees rarely resume covered employment, but if this question is raised by a client, watch out because reemployment rules are complex
  - Example: client gets unreduced pension from 55-60 and the ER wants him to come back, but when he retires after reemployment, the plan combines all his service credit, but reduces his benefit by the 55-60 payments. Is that legal, common, fair?
- Over the past several years, employers have been adopting ‘derisking’ strategies, so more common now to offer a lump sum (rollover right mandatory) even for retirees in pay status
- Last July, Treasury announced last month that they intend to prohibit “de-risking” by offering a lump sum 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. - See more at: http://www.pensionrights.org/newsroom/items/irs-and-treasury-say-no-more-lump-sum-offers#sthash.SC5mdiV1.dpuf

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New Fiduciary Rules

- New “best interest” rules issued by DOL 4/8/16 – will also be covered later in this program
- An entity is a “fiduciary” it provides advice not only as to DC plan investments, but also as to:
  - whether to receive a distribution
  - whether to elect a lump sum
  - whether to roll over the lump sum to an IRA or another plan

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New Fiduciary Rules

- Example: a 401k plan record keeper receives phone calls from participants asking questions about rollovers to IRAs
- It may recommend a rollover to an IRA managed by its affiliated bank or insurance company (a conflict of interest)
- If so, the record keeper is a fiduciary acting as such in giving this advice (thus must act prudently for exclusive purpose of providing benefits, etc.)

17

New Fiduciary Rules

- Because of the conflict of interest, the new rules require:
  - Disclosure to participants (of the conflict and fees)
  - Adoption by the advisor of rules designed to minimize the conflict of interest
  - Those rules must be posted on a publicly available website.

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June 1, 2016

Deciding When to Retire[1]: Legal Constraints

Basic Law

NRA: The definition of normal retirement age (NRA) is used for various purposes, including vesting, the various benefit accrual rules (the "accrued benefit" in a DB plan is usually a straight life annuity under the plan's formula commencing at NRA), and legal rights to commencement of benefits. ERISA prohibits a NRA later than the later of age 65 or the 5th anniversary of participation[2]. Note that the 5th anniversary aspect is for employees hired after say age 59 (DB plans often use this feature; typically DCs do not[3]).

Age generally: Participation, vesting, and accrual rules for older employees:

- IRC section 410[4] (ERISA section 202(a)(1)(A)(i)) prohibits an age requirement for participation later than age 21 (25 in some cases).
- The first sentence of IRC section 411 (ERISA section 202(a)) requires full vesting upon the attainment of NRA.
- IRC section 411(b)(1)(H) (ERISA section (204)(b)(1)(H)) governs accruals[5] after NRA.

[1] Note that the word "retire" is systematically ambiguous. It can mean either i) permanently ceasing to be employed or ii) commencement of retirement benefits. These often occur on the same date, but they do not have to be the same date, either under the law or under pension plan documents.

[2] IRC section 411(a)(8) (ERISA section 3(24)).

[3] Why this difference? Ans: NRA is part of the definition of accrued benefit for traditional DBs (not hybrids) so it has material cost implications for a DB plan, but not for a DC plan or hybrid DB.

[4] Allocation of DOL/IRS Authority before the Employee Retirement Income Security Act of 1974 (ERISA): almost all pension rules were in the Internal Revenue Code (IRC), consisting of rules which were both tax-inspired and also protected rank and file employees (e.g., non-discrimination in coverage and benefits to ensure the tax subsidies were not limited to highly compensated employees, officers, or owners; plus exclusive benefit and non-reversion rules to ensure plan assets went to participants). Accordingly, pre-1974, the Congressional committees having jurisdiction over pensions were the tax committees: the House Ways and Means Committee and the Senate Finance Committee. The House and Senate Labor Committees wanted oversight authority when ERISA was being adopted (some of the 1974 reforms were to protect workers, having little or no tax significance), so 4 bills were introduced by each of the 4 committees, and the bills were merged to produce ERISA, with substantially the same rules largely in two locations: the IRC and ERISA.

Allocation of Interpretive Responsibility: This overlapping jurisdiction led to problems (one agency interpreting its rules and the other left out or disagreeing with the interpretation) that were resolved by the Reorganization Act of 1978 under which in general: the Department of Labor (DOL) interprets and enforces the ERISA reporting, disclosure, fiduciary, and claims procedure rules and Treasury/IRS interprets the ERISA eligibility, vesting, benefit accrual, and J&S rules. Thus, interpretations of many of these ERISA protections will be found in the tax law, rather than the labor law (and in some cases you may also need to check interpretations issued by DOL before 1978).

Citations herein cite the IRC first if tax law interpretations govern, and vice versa if DOL interpretations govern.

[5] However, the backloading rules (which constrain accrual patterns that would end run the vesting rules) generally do not apply after NRA. IRC section 411(b)(1)(A)-(C) (ERISA section 204(b)(1)(A)-(C)).

- IRC section 401(a)(14) (ERISA section 206(a)) requires that participants have the right to commence benefits not later than 60 days after the close of the plan year in which occurs the latest of (A) the participant attains age 65 (or NRA if earlier), (B) the 10th anniversary of participation, or (C) the date the participant terminates service with the employer.

See also EEOC regulations (especially section 1625.10) for various ADEA rules relating to pension plans.

Early Retirement: Typically is a pre-NRA combination of age and service (or just age or just service). Tends to be of significance only for DBs and only for purposes of commencement rights[6] and early retirement subsidies.[7]

Plan Provisions and Amendments to Reduce Benefits: The plan document has to reflect any special rules the plan has for working past NRA.[8] The anti-cutback rules apply generally to the accrued benefit, early retirement benefits, and optional forms of payment (including benefit payment commencement rights). IRC section 411(d)(6) (ERISA section 204(g)). For a list of the kinds of benefits to which the anti-cutback rules do not apply, see Treas. Reg. section 1.411(d)-3(g)(2) (defining ancillary benefits).

How Retirement Plans Tend to Work

1) **DC Plans** (such as 401(k), profit sharing, stock bonus, ESOP, and money purchase plans, such as IRC section 403(b) plans)

- Implications of working past NRA
  - Earnings continue[9] to accrue.

[6] A plan has to allow benefits to begin at 65 for a former employee (with more than 10 years participation), but no rule requires benefits to be able to commence early. However, whatever commencement rights apply for early retirement also have to apply for terminations before eligibility for early retirement, e.g., if early retirement is age 55 and 10 years of service, then an employee who terminates employment at age 45 with 10 years of service has to be permitted to commence benefits at age 55. IRC section 401(a)(14) and Treas. Reg. section 1.401(a)-14. The rules allowing deferral rights do not apply if the present value of the benefit does not exceed $5,000. IRC section 411(a)(11) (ERISA section 203(e)).
Sometimes early retirement has other uses under an employer's plans, such as eligibility for retiree medical rights.

[7] An early retirement subsidy is a right to receive benefits before NRA which are more valuable than the NRA benefit. For example, if a 55-year old participant's normal retirement benefit is $1,000 a month commencing at NRA, the benefit commencing at 55 would be of equal value if it is reduced by 1) interest (the income stream at 55 commences 10 years early), 2) change in life expectancy (a p's life expectancy is longer at 55 than at 65, and 3) pre-commencement mortality (the chance that the p will die before commencement (i.e., before NRA) with no death benefit under the plan excluding death benefits that are not part of the accrued benefit). Note that Social Security reduces benefits for early commencement by about 6.7% annually, and a DB plan reduction of 60% for commencement at 55 would not be unusual. See also footnote 17 below.

[8] Treas. Reg. section 1.401-1(b)(1) requires that the benefits under a pension plan be "definitely determinable" (the IRC has a peculiar definition of a pension plan), which is usually interpreted to mean that an independent third party must be able -- using only the terms of the plan and with knowledge of a worker's age, employment history, pay, etc – to calculate how much will be payable and when.

[9] There is no law saying this directly. However, the definition of a defined contribution plan requires earnings, so a plan that provides for earnings to stop at NRA (or any other date) would by definition not be a DC plan, which means the plan has always been a DB plan which is subject to all the DB plan rules (actuary, 5500 filings, disclosure, backloading (which often involves very large penalties), etc.).

        - Of course, this means losses also can occur, so working past NRA (normally age 65 in DC plans) often involves transitioning investments to reduce risk. So called "life cycle" or "target date" investments (which most plans offer and are generally widely recommended for older workers who have sufficient retirement savings, at least where the fees are low) do this automatically.
    - Contributions are also required to continue for participants working past NRA. IRC section 411(b)(1)(H)(2) (ERISA section 204(b)(1)(H)(2)).
        - Thus, DC participants working past NRA get <u>both</u> earnings and contributions.
    - DC plans almost always[10] provide for the account balance to be paid to the participant's beneficiary upon death and thus applies for death while employed after NRA.
    - Some plans allow benefits to commence at or after NRA even for active employees (but this is not typical).
- Implications of working past age 70
    - Benefits have to commence beginning around age 70 ½ for former employees, the self-employed, and 5% owners of the employer maintaining the plan, but <u>not for active employees who are not 5% owners</u>.
    - These rules mandate that a minimum fraction (percentage) be paid annually. [11]
    - Failure to satisfy these rules is a plan disqualification failure and potentially a 50% excise tax on the participant or beneficiary. However, the tax is rarely imposed and is commonly waived (for reasonable error with steps to remedy the failure). IRC section 4974(d). Because failure to satisfy these requirements (IRC section 401(a)(9)) is a qualification failure, the employer can and typically would correct the failure under the IRS's correction program "EPCRS" (see Rev. Procs. 2013-12 and 2015-27).[12]
- What are the tax implications of working past NRA for the participant?
    - Same as apply before NRA[13]: except as indicated above, all the same rules apply to contributions and distributions as apply before NRA. IRC section 401(a)(9) and Treasury Regs. sections 1.401(a)(9)-1 to -9.
- What implications does it have for the spouse, if any?
    - Same as apply before NRA. Most DC plans provide for the account balance to be payable to the spouse or designated beneficiary. [14]
- What factors should a participant take into consideration when deciding whether to continue working?

[10] IRC section 401(a)(11)(iii)(B)(I) (ERISA section 205(b)(1)(C)) and IRS Rev. Rul. 2012-3. Copies of IRS guidance since 2000 such as revenue rulings and procedures can be found at: www.irs.gov, enter retirement plans guidance in the Search box, then Published Guidance.

[11] The fraction for a married person who will be 70 at the end of the year (and whose spouse is not more than 10 years younger) is 1 divided by 27.4 (the number 27.4 approximates a joint and survivor life expectancy for 2 people of about that age), the next year is 1 divided by 26.5, the next year is 25.6, etc. Treas. Regs. section 1.401(a)(9)-9, Q&A-2 (Uniform Lifetime Table). For an account balance that <u>appreciates at a steady pace</u> (say 7% annually), this tends to result in slightly larger payments each year until a late age (close to the midpoint for life expectancy) after which payments decline (but never to zero).

[12] Because tax-qualified plans are required to comply with IRC section 401(a)(9), plans will typically correct errors under EPCRS, but IRAs are more under the control of the participant so that IRA corrections are often the participant's responsibility.

[13] However, a special 10% income tax applies to distributions made before age 59 ½, subject to a lengthy list of exceptions (IRC section 72(t)).

[14] See footnote 10.

- Have you saved enough to retire? If so, you could cease 401(k) contributions (but maybe only amounts that would not be matched). If not (which is more likely), think about increasing your 401(k) contributions (including the age 50 catchup at IRC sections 402(g)(1)(C) and 414(v)(2)(B)).
    - A major risk of relying on DC plan (and IRA) savings in retirement is the risk that you or your spouse may live longer than your DC/IRA savings last, so consideration should be given to how to address this longevity risk.
    - Social Security benefits increase significantly if you delay commencement past your Social Security retirement age (generally age 67 depending on date of birth):
        - 8% annually which may be a very attractive guaranteed rate of return
    - These kinds of consideration generally do not involve legal issues a participant might raise, but see also the discussion at the end of this paper regarding fiduciary obligations regarding retirement planning.
- What if you decide to retire and then change your mind and return to work
    - Generally, you would resume participation immediately (assuming you return within 5 years). IRC section 410(a)(4)(D)(i)(I) (ERISA section 202(b)(4)(A)(i)).[15]
- Note that the rules governing DC plans frequently also apply to IRAs and IRA savings should obviously be considered in decisions about whether to retire.
- Note also that if a participant is eligible for a payout from a DC plan, there is usually no material cost difference in being paid out immediately or later (because the account balance is what is payable regardless of the timing) -- unlike a DB plan when being paid out immediately or later can in some cases materially affect the value of the benefit. Note also that a lump sum payout can be rolled over into an IRA so that no real "retirement" payout is occurring (the retirement savings are just being moved from one pocket to another), though there can be cost (higher fees in an IRA are common) and investment implications.

2) **DB Plans** (traditional pension plans, not a plan where each participant has an account balance that represents his or her interest in the plan's assets)

Much more complex rules apply to DB plans than DC plans (but DBs have some rules in common with DC plans)

- Typically, the most important DB implication of working past NRA is that the value of the additional annual accrual goes down.
    - A DC plan has to provide for both contributions and earnings, as discussed above, but a DB plan only has to provide for continued accruals, and is not required to also provide an actuarial increase (see footnote 7 for a list of the 3 early commencement factors that also go into an actuarial decrease).
    - If a plan fails to provide an actuarial increase, then the plan is required to notify employees that they are losing ("forfeiting" in the statutory language) some of the value of the benefit payable at NRA. See ERISA section 203(a)(3)(B) (IRC section 411(a)(3)(B)) and DOL Regs. section 2530.203-3. If the plan fails to provide the notice, then the participant is entitled to an actuarial increase. Note that the form of this right is the greater of (i) the accrued benefit taking post-NRA accruals into account or (ii) the

[15] See DOL Regs. section 2530.203-3.

actuarially increased value of the benefit payable at NRA. When is (i) likely to exceed (ii)? Note that these rules are very unclear (little guidance, lots of questions[16]).
    - To avoid having to give the notice, some plans provide the greater of the accrued benefit or an actuarial increase. A few DB plans give the sum of (i) the accrued benefit at NRA actuarially increased to commencement date plus (ii) continued service accrual credit for working after NRA.
- Implications of working past age 70
    - Generally the same as apply for working after NRA (similar to implications of working past age 70 in a DC plan as discussed above).
- Implications of working to or past an early retirement age
    - Many of the same kinds of questions apply for working after an early retirement age as apply to working after NRA. For example, the value of the annual additional benefit under a DB plan increases if there is no early retirement <u>subsidy</u>, but declines (or fails to increase as much) as you work past a <u>subsidized</u> early retirement date. Moreover, if the plan subsidizes early retirement, then any employee nearing that early retirement age should try to continue working to that age in order to obtain the subsidy.[17]
    - Note that in DB plans that have an early retirement subsidy and which also offer a lump sum payout, it is common for the lump sum to NOT include the subsidy.[18]
- Does it make any difference if the plan is frozen or terminated?
    - Not generally, but terminated plans sometimes allow benefits to commence immediately.[19]
- What are the tax implications for the participant of working past NRA?
    - Same as apply for before NRA.
- What implications does it have for the participant's spouse, if any?
    - The death benefit requirements under a DB plan for a participant working past normal retirement age do not change, i.e., no death benefits are required apart from the same joint and surviving spouse rules and rules for employee contributions (if any). But sometimes DBs have special death benefit rules which apply to participants working after NRA, e.g., DB plans for union employees may have a small lump sum payable for death after NRA (to help cover burial expenses) and some DBs have a "full reserve" death benefit (equal to the present value of the accrued benefit that would have been payable if the participant had instead commenced benefits on the date of death).

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[16] Is the actuarial increase limited to the NRA accrued benefit or does it also include the additional accrued benefit for each of the post-NRA years?

[17] Here is a 'stylized' example to give a sense of how valuable an early retirement subsidy in a DB plan can be: An actuarial reduction from age 65 to age 55 might be say a 60% reduction (or more – or less -- depending on the interest rate used, etc.), so $10,000 monthly for life beginning at 65 would result in a $4,000 monthly actuarially equivalent annuity for life beginning at 55. Conversely, if a life annuity at 65 has a present value at age 65 of say $100,000, but that same life annuity payable at 65 is also payable in the event of early retirement at or after 55, then the present value at 55 might be $250,000. Thus, in this example, termination of employment just before age 55 could result in a loss of $150,000 in pension value!
Similar actuarial factors can apply to post-65 commencement, depending on whether or not the plan provides an actuarial increase (but taking the effect of continuing accruals into account). See also footnote 7.

[18] The minimum lump sum rules (IRC section 417(e)(3) (ERISA section 205(g)(3)) do not require the lump sum to include the subsidy, but do require disclosure of the relative value (see, e.g., Treas. Regs. 1.417(a)(3)-1(e), Example (2).

[19] As early as age 62 is allowed for active employees. IRC section 401(a)(36).

- What other factors should a participant take into consideration when deciding whether to continue working?
    - Do you like your work, or do you want to do something else? What does your family think?
    - Generally, the same considerations as described above for DC plans apply (such as do you have enough to retire on?), but
        - As discussed above, if a DB plan does not provide both continued accruals plus an actuarial increase, the value of the additional annual accruals declines.[20]
        - But the monthly pension amount increases too, so you have a larger monthly income to live on.
        - These two conflicting ideas are difficult for non-actuaries to understand.
- A participant whose health takes a turn for the worse should consider the additional death benefits that may be available in the event death occurs after commencement of benefits (such as a lump sum or a 100% survivor annuity) and evaluating this taking into account the short term risk of death. This idea (often referred as death-bed elections) also applies for purposes of deciding whether to retire early. Plans sometimes have special rules to restrict death-bed elections, such as requiring the election to be made some period (such as 90 days or 6 months) in advance.
- What if you decide to retire[21] and then change your mind and return to work?
    - These rules are very complex. See IRC sections 411(a)(7)(C) , 411(a)(6) and 410(a)(5).
    - A common approach is to calculate the benefit payable after reemployment (the second retirement) by reducing the accrued benefit payable by the actuarial value of the payments previously made before the second retirement. Note that this means the NRA benefit is reduced not only by the portion already paid, but also by any early retirement subsidy that was paid.
    - An alternative approach is to reduce the accrued benefit by the value of the payments made only to the extent of the normal retirement benefits paid (not any early retirement subsidy).
    - Because of the complexity of these rules, plan documents are commonly poorly drafted and hard to read on these issues.
- Hybrid plans. 1) Cash balance pension plans: annual accruals under a cash balance plan include both a 'pay credit' and an 'interest credit.' For example, a pay credit might equal say 6% of pay, so the pay credit for a $50,000 salary employee would be $3,000. The interest credit depends on p's prior balance and the plan's interest crediting rate, e.g., a 5% interest credit on a $50,000 account balance results in a total balance of $55,500 (3,000+2500). At retirement, cash balance plans offer lump sums equal to account balance, or actuarially equivalent annuities (incl QJSA) 2) Pension Equity Plans: Another kind of hybrid are pension equity plans (PEP) which have serious legal compliance issues. It is illegal for the aggregate accrued benefit to decline[22], but this can occur if a PEP credits interest after termination of employment[23]
- Derisking. Employers in recent years have taken steps to reduce funding risks, such as offering retirees lump sums and buying out their annuities. Last July, Treasury announced last month

[20] A similar result applies to returning to work after early retirement in a plan that substantially subsidizes early retirement benefits.
[21] Note that the word "retire" here means commencement of payments.
[22] IRC section 411(b)(1)(G) (ERISA section (204)(b)(1)(G)).
[23] Normally, PEPs typically credit interest after termination of employment to avoid a backloading violation under IRC section 411(b)(1)(A)-(C) (ERISA section (204)(b)(1)(A)-(C).

that they intend to prohibit "derisking" by offering a lump sum 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.[24]

3) **New Fiduciary Rules**

The Department of Labor last month issued a new set of rules regarding "fiduciary" duties under ERISA, including broadening the types of conduct that constitute fiduciary acts. Under the new rules[25] (sometimes called the "best interest" rules), not only investment advice, but advice to a participant or beneficiary regarding the following are for the first time fiduciary acts (so that the adviser must act in the "best interest" of the participant or beneficiary):

- whether to receive a distribution
- whether to elect a lump sum
- whether to roll over the lump sum to an IRA or another plan

Advisors addressing these types of decisions often have a conflict of interest, e.g., a 401k plan record keeper may respond to phone calls from participants by recommending a rollover to an IRA managed by its affiliated bank or insurance company[26] (such as a rollover into a complex insurance annuity issued by its affiliate). Because advice regarding these decisions is now fiduciary advice, the advisor has to be prudent, including presumably collecting information on plan fees, investments and rights (including for a DB plan, consideration of the annuity value compared to the lump sum offered).

The new rules include:

- Disclosure to participants
- Adoption by the advisor of rules designed to minimize the conflict of interest
- Those rules must be posted on a publicly available website.

Thus, if you think a client might have been injured by such advice (or any other investment advice), you can go onto the advisor's website to see if it violated its own rules. The new best interest rules are expected to result in lawsuits, including a challenge to the authority for the best interest rules and potentially class actions for violations.

[24] See more at: http://www.pensionrights.org/newsroom/items/irs-and-treasury-say-no-more-lump-sum-offers#sthash.SC5mdiV1.dpuf

[25] See Federal Register 4/8/16 or go to www.dol.gov, then hit Final Rules in the left-hand column.

[26] A recent survey supposedly showed that 60% of all rollovers are made to an entity that is affiliated with the plan record keeper or other plan investment manager for the plan.

Should you take your Pension as a lump sum?

Some companies have offered to cash out the pensions of their retirees and former employees[1] by offering them a one-time, lump-sum payment.

While the idea of suddenly having a large sum of money is tempting, **deciding whether to take a lump sum is a decision that will affect you for the rest of your life.** By accepting a lump-sum offer you will lose the benefit of monthly pension income that lasts a lifetime – and you cannot change your mind. Electing to take a lump sum is an irrevocable decision that means taking responsibility for deciding how to invest the money and making sure that it lasts throughout your retirement years.

For most retirees, **a pension in the form of a guaranteed lifetime stream of income is a better option than a lump sum.** The only situations in which a lump sum should be seriously considered are:

– If you have a health condition so severe that you don't expect to live long and you do not have a spouse who will need lifetime income after your death; or

– If you are so wealthy you don't need a pension, or you have another secure source of lifetime income (such as a spouse's pension) that you do not need lifetime income during your retirement years.

If you are considering whether to take accept a lump-sum buyout, take the following concerns into account:

– **Is there a chance that I or my spouse could live a long time?** Your lump sum is calculated based on average life expectancies. If there is any chance that you or your spouse will live longer than this average, you should choose a pension instead of a lump sum that might not be enough. The reason for this is simple: a pension will provide you and your spouse with "longevity protection," the guarantee that you and your spouse will continue to receive your monthly pension no matter how long you and your spouse live. **Longevity protection is a valuable economic right that is forfeited by those who take a lump sum**.

– **Can I afford to lose some or all of the money?** If you take a lump sum, you are the only person responsible for taking care of your investments. Do you have the

[1] In July 2015, the Internal Revenue Service and the U.S. Treasury Department announced that they would prohibit companies from offering lump-sum buyouts to retirees who are already receiving a monthly pension. This will help to stop some of the most harmful practices associated with pension derisking. This change only affects retirees. Lump-sum buyouts continue to be permitted for former employees entitled to pensions but who haven't begun to receive their benefit.

financial acumen to prudently invest the money? Can you withstand the significant fluctuations of the stock market? If you are wealthy enough that you can withstand investment losses, you have greater flexibility to consider taking a lump sum.

– **How good are my investing skills? How good are my spouse's investing skills?** If you already own stocks and bonds, look at your past investment history. Can you earn enough through investments to make the lump sum grow and last throughout your retirement years? Can you stay on top of your investments as you age? Bear in mind that retirees generally should invest much more conservatively than younger workers, and, therefore tend to have lower investment returns. Further, if you take a lump sum and then die, it will be up to your spouse to make the money last though his or her lifetime.

Differences Between Lifetime Payments and a Lump Sum		
	Lifetime Payments (Annuity) (whether from your pension plan or an insurance company)	**Lump Sum**
Is my income guaranteed?	Yes*	No
What if I live longer than expected?	I continue to receive my monthly income	I can run out of money
How is the money distributed?	In a continuous stream of lifetime payments	All at once, now
Am I responsible for investing the money?	No	Yes
What if the stock market falls or I make bad investments?	My monthly income is safe*	My money can be lost
Do I pay investment management or other fees?	No	Yes, and fees can be high
Is the money protected against inflation?	Only if my pension or annuity includes a cost-of-living adjustment	Only if I am willing to accept low returns or risk investment loss
Can I leave anything for my spouse or children?	Yes, if I chose a survivor benefit for my spouse or ex-spouse.	Yes, if there is money left when you die
*Subject to certain limits. Payments from your pension plan are backed by your employer and the Pension Benefit Guaranty Corporation. If your annuity comes from an insurance company, those payments are guaranteed by the insurance company and are backed by state insurance funds.		

- **What are the tax implications of the lump sum?** If you take the lump sum and don't roll it over directly into an IRA, the lump sum will be counted as income for the year. Depending on the amount, taking a lump sum may push you into a higher tax bracket. Individuals younger than age 59 ½ will have to pay 10 percent tax as a penalty for early withdrawal.

- **How large is my current pension benefit?** If your pension is paid by your former employer and that employer goes bankrupt, the Pension Benefit Guaranty Corporation (PBGC), the federal pension insurance agency, might assume responsibility for your pension. The PBGC has limits on the benefits that it can pay (it's over $60,000 annually for a pension beginning in 2015 at age 65), so your monthly benefit might be reduced. However, the vast majority of retirees who get their benefits from the PBGC receive the same amount that they were getting before the PBGC took over their plan.

  If your annuity comes from a private insurance company, then, in the unlikely event that the insurance company goes under, your benefits will be guaranteed up to certain limits by insurance industry state guaranty associations. These limits vary depending on where you live. (See our related fact sheet, What Happens When a Pension is Transferred to an Insurance Company?)

- **Can I change my mind later?** The decision to take a lump sum instead of a pension is irrevocable. However, you can purchase an annuity from an insurance company. These annuities typically are very expensive and, as a result, you are likely to receive a lower monthly payment than if you had stayed with the pension or any annuity purchased by the plan. To find out how much of an annuity you might be able to purchase with your lump sum, use an annuity calculator, such as the one found on ImmediateAnuities.com.

- **Women should take special note at the next point:** Individual annuities tend to be more expensive for women because they are charged more for insurance annuities than men are because annuity providers assume that, as a group, women have a longer life expectancy than men. Women do not face such discrimination when getting a traditional pension or an annuity that is purchased by the pension plan.

- **What is the impact on my other retirement benefits?** If you have earned the right to receive special early retirement benefits or subsidized survivor benefits, you could loose these subsidies if you take a lump sum. If this applies to you, the amount of the subsidy you will lose will be described to you in your retirement election disclosure forms the plan will provide you.

Other key points:

1. Unless you have other sources of income, **don't be tempted to take a lump sum for non-retirement purposes,** such as paying off debt, paying for everyday expenses, or helping out family or friends.

2. **Check into the financial interests of anyone advising one option over another.** For example, a financial adviser might urge an individual to take a lump sum because the adviser will get fees from managing the money or commissions for selling you certain products. These fees and commissions will lower your rate of return.

3. Some retirees have expressed concern about the long-term stability of an annuity provider, whether it is an insurance company or the Pension Benefit Guaranty Corporation. For most people, **the risks posed by taking a lump sum still outweigh the remote possibility that an established financial institution or the PBGC will not be able to continue to make payments.**

4. **Make sure that your employer has the correct information** regarding your age, salary, dates of employment and any spousal or other benefit you have chosen.

5. **Make sure that your employer gives you all of the information that you need to make an informed decision.** A 2015 Government Accountability Office study found that lump-sum offer packages routinely lack key pieces of information that the recipient should have, such as the formula used to calculate the lump sum.

6. If you think your benefit has been calculated incorrectly, assistance may be **available from the U.S. Administration on Aging's** Pension Counseling and Information Program, which provides free legal counseling (not financial advice) in 30 states.