

# De-Risking Defined Benefit Plans: Tax and ERISA Issues

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# De-Risking a Defined Benefit Pension Plan: The Employee Benefit Lawyer's Perspective

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- Distribution strategies
  - Lump sum window
    - ❖ Participants not yet in pay status
    - ❖ Participants who have commenced annuity distributions
  - Distributing annuity contracts
  
- Termination strategies
  - Spinoff/termination of former-employee liabilities
  - Plan termination
  
- Portfolio investment strategies
  - LDI
  - Longevity swaps
  - Portfolio hedges
  - Buy-in
  
- Plan design strategies

# Lump Sum Window – Participants Not In Pay Status

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## ■ Funding and qualification issues

- IRC § 436(d) – “prohibited payments” limited unless AFTAP  $\geq$  80%
- IRC § 436(c) – unless post-amendment AFTAP  $\geq$  80%, amendment may not “have the effect of increasing liabilities of the plan” by “new benefits” including new lump sum option. See Treas. Reg. § 1.436-1(a)(4)(v), Example (1)(iv)
- Interest rate – New stability period and/or lookback month? See Treas. Reg. §§ 1.417(e)-1(d)(10) (relationship with IRC § 411(d)(6)) and 1.417(e)-1(d)(4) (uniform applicability rule)
- Optional forms – Protected for available distributions. IRC §§ 411(d)(6), 417. For newly available distributions offer normal, QJSA and QOSA forms
- Consent – IRC §§ 411 and 417

# Lump Sum Window – Participants Not In Pay Status (Continued)

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## ■ Fiduciary issues

- Disclosure - *e.g.*, if lump sum does not include supplements and subsidies, is this adequately disclosed?
  - ❖ Is plan's standard "consequences of failure to defer" notice adequate?
  - ❖ Some limitations on the utility of relative value statements
- Serious consideration

## ■ Other issues

- Grandfathered SERPs linked to qualified defined benefit plan distribution form – possible 409A issues
- Collectively bargained plans
- Excluded groups

# Lump Sum Window – Participants In Pay Status

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- Same issues as for participants not in pay status, PLUS
  
- Qualification issues
  - Treas. Reg. § 1.401(a)(9)-6, Q&A-14
    - ❖ PLRs 201228051, 201228045 (lump sum offer to annuitants in pay status constitutes “increased benefits that result from a plan amendment”)
  - It’s a new annuity starting date – Section 415 limits apply for multiple annuity starting dates. Treas. Reg. § 1.415(b)-1(b)(iii)
  - Rollovers for age 70 ½+ group - Treas. Reg. § 1.401(a)(9)-6, Q&A-1(d)
  - Spousal consents for remarried divorced participants - when is former spouse consent required? Treas. Reg. Sec. §§ 1.401(a)-20, Q&A-31(b), 1.417(e)-1(b)(2)(i); PLR 201228051, n.5; PLR 201228045, n.3.

# Lump Sum Window – Participants In Pay Status (Continued)

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- Excluded groups
  - ADEA concerns – Defense to possible disparate impact claims must meet *Smith v. City of Jackson* standard – “reasonable factors other than age”

# Distributing Annuity Contracts

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- Tax qualification issues
  - Distribution of annuity contract is a “prohibited payment” for purposes of IRC § 436(d) – unrestricted only if AFTAP  $\geq$  80%
- ERISA issues
  - ERISA § 502(a)(9) – annuity distributees have standing to claim “appropriate relief” if annuity purchase is a fiduciary breach or violates the terms of the plan
  - Absent § 502(a)(9) breach, practitioners generally believe that plan’s obligation is discharged to extent of distribution of annuity contract from non-terminating plan. See 29 CFR § 2510.3-3(d)(2)(ii) (individual no longer a plan P or B after issuance of annuity contract providing for benefit payment)
- PBGC concerns?
  - *Compare* PBGC request for public comment on purchase of irrevocable commitments before plan termination, 74 Fed. Reg. 61074 (Nov. 23, 2009) *with* PBGC no-action notice, 75 Fed. Reg. 82095 (Dec. 29, 2010)

## Distributing Annuity Contracts - *Lee v. Verizon*

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- *Lee v. Verizon Communications, Inc.*, N.D. Tex. No. 3:12-cv-04834-D
- December 10, 2012, Verizon paid Prudential \$8 billion premium to assume \$7.5 billion pension obligation to 41,000 retirees in pay status
- Assets will be in “separate account,” not available to Prudential creditors; obligations also backed by Prudential general account
- Plaintiffs filed motion for preliminary injunction, *denied* December 7, 2012; plaintiffs did not appeal
- Plaintiffs have continued with claims that annuity purchase was fiduciary breach, violation of ERISA disclosure obligations and ERISA § 510 interference with protected rights
- Verizon has filed motion to dismiss
- PBGC silence to date



# Plan Terminations and Spinoff Terminations

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- Plan Sponsor's Decision:
  - Terminate whole plan?
  - Spinoff termination of retiree liabilities only?
  
- Are spinoff terminations extinct after the Verizon transaction?

# Annuity Purchase – Fiduciary Checklist

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- Similar fiduciary issues arise, whether annuity purchased in connection with plan termination or Verizon-type transaction
  
- Create the fiduciary structure
  - Determine identity and composition of in-house fiduciary
  - Decide whether to retain independent fiduciary, and if so, in what role
  - Retain needed independent experts (annuity placement advisor; advisors in federal tax and securities law, ERISA, state insurance law, actuarial expertise, etc., according to fiduciary's determination of needs)
  - Negotiate and execute compensation, indemnification and confidentiality agreements
  - Establish communications protocols

# Annuity Purchase – Fiduciary Checklist (cont.)

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## ■ Select the annuity provider

- “Safest available annuity” standard of DOL IB 95-1: Is this the law? What does it mean?
  - ❖ Size of insurer relative to contract
  - ❖ Structure of annuity
  - ❖ State guarantee associations
  - ❖ Is cost a permitted factor?
- Initiate and complete data cleanup
- Initiate and review annuity advisor’s list of selected annuity providers
- Conduct request for preliminary annuity proposals
  - ❖ Note – Acceptance window for final bids likely to be a few hours – request for preliminary proposals is essential
- Review proposal and resolve any issues with annuity providers
- Obtain final bids on the basis of preliminary proposals
- Select annuity provider

## Annuity Purchase – Fiduciary Checklist (cont.)

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- De-risk plan asset portfolio
  - Devise investment strategies including transition portfolio
  - Initiate and complete orderly disposition of illiquid and hard-to-value assets
  - Procedure for dealing with assets in master trust holding assets of different plans
  
- For annuity purchase in connection with plan termination: Furnish all required government filings and participant notifications
  - Submit PBGC filings according to PBGC timetable
  - File for IRS determination letter, including submission of required plan amendments
  - Submit any required filings to state insurance commissioners

# Portfolio Investment and Plan Design Strategies

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- Portfolio investment
  - ERISA standards of prudence, care and loyalty apply
  
- Plan Design
  - Variable annuity structure
    - ❖ New benefits only
    - ❖ 5% rate or hybrid plan rules apply