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IRS Reopens Opportunity to Cash Out Retirees in Pay Status—At Least For Now

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One de-risking tool for employers with defined benefit pension liabilities is to allow participants to receive lump-sum distributions. Although lump sums result in a short-term cash drain, they reduce the plan's long-term liability—reducing the sponsor's exposure to contribution volatility.

Over the last several years, there has been a question whether lump-sum cashouts may be offered to retirees who are already receiving annuities. Ironically, the concern was based on the IRS's minimum required distribution rules. Although the purpose of minimum required distributions is to force participants to take their money, the rules prohibit an increase to the payment amount after payments start, subject to limited exceptions. The concern is that a lump-sum cashout could be a prohibited increase to the payment amount.

In 2012, the IRS issued two Private Letter Rulings that said a cashout would not be prohibited if (1) cashouts are available only during a limited window and (2) annuitants did not previously have a right to cash out annuities in pay status. The IRS reasoned that, under those circumstances, the increase to the payment amount is caused by an amendment to increase benefits, which is one of the limited circumstances when an increase to the payment amount is permitted. The IRS's conclusion was consistent with the underlying policy of minimum required distributions: if the annuity in place will pay out fast enough, cashing out must be okay because it results in payment being made even faster.

Following those rulings, many employers looked into offering cashout windows to retirees in pay status. Seeing the interest, IRS officials stated informally that it considered the analysis in the Private Letter Rulings to be settled law, and the IRS issued favorable determination letters for plans that allowed cashout windows.

But the IRS changed course in 2015. In Notice 2015-49, the IRS recanted its 2012 analysis. Instead, the IRS said it intended to amend its minimum required distribution regulation to state that cashing out annuities in pay status would be a prohibited acceleration; the IRS also said the new regulation would be effective July 9, 2015. With that, the opportunity to cash out annuities in pay status went away.

In the time since, the IRS never issued the intended regulation, and the project was eventually removed from the Treasury Department's Priority Guidance Plan. On March 6, 2019, in [Notice 2019-18] the IRS announced that it no longer intends to amend the minimum required distribution regulation. Until further notice, the IRS will not assert that a window to cash out annuities in pay status violates the minimum required distribution rules.

The IRS cautioned that it will continue to examine the issue, and nothing prohibits the IRS from changing its view. In addition, the IRS cautioned that any cashout window must comply with all of the other requirements for tax-qualification.

For now, the guidance gives plan sponsors another de-risking tool.

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