IRS Issues New Tables for Lump Sum Payments

The IRS has issued a new mortality table for the purpose of determining minimum lump sum payments for defined benefit plans, pursuant to the Pension Protection Act of 2006 (“PPA”), in Revenue Ruling 2007-67. This table, along with the interest rate tables issued recently (IRS Notices 2007-81 and 82), will now enable plan sponsors to determine the lump sum amounts under the new rules. The changes are effective for the first day of the plan year in 2008.

Impact
As expected, minimum lump sum payments will generally be smaller in 2008 under PPA, compared to what they would have been under prior law. Based on the interest rates published for September, the change in lump sum value is slight for those in the retirement years (down about 1.7% at age 60 and 0.7% at age 70) and larger for those taking lump sums at earlier ages (down about 7.7% at age 40 and 4.3% at age 50).

Background
The law prior to PPA provides that lump sum payments must be at least equal to those determined assuming the so-called “GATT” assumptions, which are the GAR ’94 mortality table (unisex basis) and an interest rate based on 30 Year Treasury Bond yields. This basis was commonly thought to provide lump sums that were excessive, especially when issuance of new 30 Year Treasury Bonds was suspended. It was argued that the yields of existing 30 Year Treasury Bonds were artificially low, and therefore the lump sum payments were too high. This dynamic, in turn, increased funding pressure on pension plans.

Congress included a revision to this basis in PPA, changing the interest rate basis to a corporate bond yield curve, using three segment rates to approximate a full yield curve. One rate is used for payments within the first five years of measurement, a second rate for payments from 5-20 years and third rate for payments beyond 20 years. Use of the new yield curve basis is phased in over a five year period and will result in lower lump sum payments in most circumstances.

Protected Benefits Under Section 411(d)
Generally, reductions to accrued pension benefits are not permitted, pursuant to Internal Revenue Code Section 411(d). A special provision of PPA waives applicability of this requirement for the change to lump sum calculations. However, a few conditions apply: the plan must maintain the same “lookback” month and “stability period” set forth in the plan document. The “lookback” month is the first, second, third, fourth, or fifth month prior to the first day of the “stability period” for which the applicable interest rates apply. The “stability period” is simply the period of time a given set of rates is in effect, which could be for one month, one quarter, or one year. Many plans chose a “lookback” period of two or three months so that the rate could be known comfortably in advance of a given payment. The “stability period” is most often the full plan year. For example, a calendar year plan might have a “lookback” based on the published interest rate for November and would apply for all of the following plan year.

Plan sponsors have always had the right to provide larger lump sums than those determined under the GATT basis. Plans that do not use the current GATT basis for lump sums must preserve the prior basis on accrued benefits, in order not to run afoul of the 411(d) rules. In these cases,
participants’ lump sums would be the larger of those determined under the prior basis or under the PPA basis. In contrast, a plan that only had the GATT definition can move to the PPA basis without having to preserve anything.

The following chart shows the impact of the new PPA basis compared to the current GATT basis. The third column reflects the impact if just the mortality table were changed. Column five displays the impact if just the interest rate basis were changed (including the phase-in of the new rates), followed by the impact of both changes combined.

**Lump Sum Value of $1 of Annual Annuity Payable at Age 65 for 2008 Lump Sums**

<table>
<thead>
<tr>
<th>Age</th>
<th>Current GATT Basis</th>
<th>New Mortality Only</th>
<th>Percentage Change</th>
<th>New Interest Rate Basis Only</th>
<th>Percentage Change</th>
<th>Both Mortality &amp; Interest Basis</th>
<th>Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>$2.1296</td>
<td>$2.2065</td>
<td>3.6%</td>
<td>$1.8397</td>
<td>-13.62%</td>
<td>$1.9057</td>
<td>-10.52%</td>
</tr>
<tr>
<td>40</td>
<td>$3.4235</td>
<td>$3.5404</td>
<td>3.42%</td>
<td>$3.0577</td>
<td>-10.69%</td>
<td>$3.1615</td>
<td>-7.65%</td>
</tr>
<tr>
<td>50</td>
<td>$5.5336</td>
<td>$5.7060</td>
<td>3.12%</td>
<td>$5.1348</td>
<td>-7.21%</td>
<td>$5.2935</td>
<td>-4.34%</td>
</tr>
<tr>
<td>60</td>
<td>$9.1288</td>
<td>$9.3385</td>
<td>2.30%</td>
<td>$8.7754</td>
<td>-3.87%</td>
<td>$8.9753</td>
<td>-1.68%</td>
</tr>
<tr>
<td>70</td>
<td>$10.4181</td>
<td>$10.5408</td>
<td>1.18%</td>
<td>$10.2220</td>
<td>-1.88%</td>
<td>$10.3419</td>
<td>-0.73%</td>
</tr>
</tbody>
</table>

The current GATT basis reflects the GAR ’94 table and the 30 Year Treasury Bond yield for September of 2007 of 4.79%. The new PPA basis reflects the RP-2000 “combined” table for 2008 and the phase-in of the segment rates (shown as “Both New Mortality and Interest Basis”). The table indicates calculations using the three segment rates under PPA for September are: 5.28%/6.12%/6.55%. The applicable phase-in is 80% of the GATT basis (4.79%) and 20% of the PPA basis (segment rates), yielding rates of 4.89%/5.06%/5.14%.

**Subsequent Years**

The lump sum values will gradually become lower (assuming a stable rate climate). While the mortality basis will continue to be improved each year (i.e., people will live longer), which would push up the lump sum value, the interest rates used for the calculation will rise due to the impact of the phase-in. For 2009, the weighting will be 60% old basis, 40% new; for 2010, 40% old, 60% new, for 2011 20% old, 80% new, and for 2012 the new basis will be fully phased in.

**Conclusion**

The impact of the new rules will be a decrease in lump sums values, and the magnitude of the decrease will vary by age at payment. Plan sponsors with only the GATT basis definition for lump sum calculations can make the change to the new basis without any restrictions. Plan sponsors that have a more complicated plan provision for lump sum calculations may have to preserve the old basis for lump sum payments of accrued benefits. The new basis should have a positive impact on plan funding, in proportion to the resulting smaller lump sums.

Plans must comply operationally with the interest rate and mortality table adjustments outlined in this PPA Update by the first day of the plan year beginning in 2008. Plan documents can be amended at a later date.

USI Consulting Group actuaries are prepared to assist plan sponsors in assessing the impact of the new tables on their lump sum payments and plan administration.

**about the author:**

J. Grant Elman is Vice President and Actuary with USI Consulting Group. He leads a team of actuaries responsible for defined benefit valuations, administration and consulting. Grant graduated from Stevens Institute of Technology with a B.S. degree in mathematics in 1983. He joined the Insurance Services office that year and went to Kwasha Lipton in 1984. He became an Associate of the Society of Actuaries in 1990 and an Enrolled Actuary in 1991. At Kwasha Lipton, Grant provided consulting services for the retirement plans of Fortune 500 companies in the manufacturing and financial service industries, was involved in several mergers and acquisitions situations and designed a number of cash balance pension plans. In 2001 he left to engage in private consulting services, where his experience included an engagement with Moody’s Investor Services on a study of the impact of pension plans on financial statements and credit ratings. He joined USI Consulting Group in 2002.