LEOFF Plan 2 Retirement Board

September 23, 2020

Survivor Reelection

INITIAL CONSIDERATION
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ISSUE STATEMENT

Allowing members to change their survivor option election after retirement may raise plan qualification issues with the IRS.

OVERVIEW

The LEOFF 2 Board endorsed legislation (SB 6417/HB 2678) last year to give LEOFF 2 retirees 90 days to change their survivor option. Towards the end of the legislative session it came to the Board's attention that there may be IRS plan qualification issues with allowing retirees a post-retirement window to change their survivor option. To address this issue, SB 6417 was amended to include language that the bill does not take effect until the state receives determination from the IRS that these changes conform to federal law. The bill passed and LEOFF 2 Board staff, along with the Department of Retirement Systems (DRS), is working with tax counsel on seeking an IRS determination.

BACKGROUND AND POLICY ISSUES

Legislative Background

After studying the issue of allowing retirees to change their survivor option after retirement, the LEOFF 2 Board endorsed legislation (SB 6417/HB 2678) to allow LEOFF 2 retirees up to 90 calendar days after the receipt of their first retirement allowance to prospectively change their survivor election.

Early in the legislative session, the bill was amended to include all DRS covered retirement plans. LEOFF 2 Board staff testified, as the LEOFF 2 Board had instructed, that this amendment would be considered a friendly amendment from the LEOFF 2 Board's perspective.

Later in the legislative session DRS reached out to their tax counsel to review the legislation for any possible plan qualification issues. Their tax counsel let DRS know they believed there would be plan qualification issues with the bill. DRS notified LEOFF 2 Board staff and legislative staff of these concerns and the bill was amended to not take effect until the state received determination from the IRS that these changes conform to federal law. The amended bill passed and was signed into law.

Federal Law (Plan Qualification) Issues

LEOFF Plan 2 is a 401(a) retirement plan. A retirement plan that meets the requirements of Internal Revenue Code (IRC) Section 401(a) is referred to as a "qualified plan." IRC Section 401(a) sets standards for retirement plans including:

- Who is eligible for plan participation,
- When participants have a nonforfeitable right to their plan benefits,
- How much may be contributed to the plan by both participant and employer, and
- When and how distributions from the plan may be made.

If a retirement plan is in violation of IRC 401(a) it is subject to penalties from the IRS.

The LEOFF 2 Board and DRS requested a legal advice memo from tax counsel regarding the plan qualification issues that had been raised during legislative session regarding SB 6417 (see Appendix B). Tax counsel concluded that they believed SB 6417 is in violation of IRC Section 401(a). Specifically, their legal analysis identified possible violations of re-annuitization treasury regulations and nonincreasing annuity treasury regulations.

Re-annuitization treasury regulations (see Treas. Reg. § 1.401(a)(9)-6, Q&A-13(b)(3)) restrict the ability to re-annuitize a pension after payments have started. These regulations only allow for an annuity payment to be changed if:

1. The modification occurs at the time the employee retires or in connection with a plan termination;
2. The annuity payments prior to the modification are annuity payments paid over a period certain without life contingencies; or
3. The annuity payments after modification are paid under a qualified joint and survivor annuity over the joint lives of the employee and a designated beneficiary, the employee's spouse is the sole designated beneficiary, and the modification occurs in connection with the employee being married to such spouse.

Upon re-annuitization, the value of the entire benefit cannot be increased by the re-annuitization. Nonincreasing annuity treasury regulations (see Treas. Reg. § 1.401(a)(9)-6, Q&A-14) provide several exceptions to this, generally including:

1. An annual percentage increase under an approved cost-of-living adjustment (COLA);
2. A percentage increase at certain specified times which does not exceed an approved COLA;
3. A "pop-up" benefit increase if a beneficiary either dies or is no longer a beneficiary under a QDRO, to the extent the benefit was reduced to provide the survivor benefit;
4. A plan amendment;
5. A beneficiary's conversion of a survivor benefit to a lump sum distribution at the employee's death;
6. A constant percentage increase less than 5%, occurring at least annually;
7. A final payment of any remaining employee contributions or accrued benefit; and
8. Certain dividend payments.

Therefore, federal law does not identify an exception to the re-annuitization and nonincreasing annuity treasury regulations that would allow a retiree to change their survivor option within the first 90 days of retirement.

IRS Determination

The amended bill requires the state to receive a "determination from the IRS". Typically, DRS, as the plan sponsor, would be responsible for seeking a determination from the IRS. In this instance, LEOFF 2 Board staff have worked with DRS and tax counsel to determine the appropriate next steps in seeking a determination from the IRS, including what type of determination to seek and whether to seek one for all Washington state retirement plans at once or by individual plan.

Tax counsel has advised that the type of determination from the IRS that we should seek is a Private Letter Ruling. The IRS charges $20,000 for a Private Letter Ruling. Tax counsel has advised that they believe the IRS may allow DRS to submit one request for all plans, as the language of the law is identical for each system. By consolidating our request to the IRS we may avoid being charged $20,000 per individual plan. Instead the cost would be spread across all of the plans. However, tax counsel has warned that the IRS may still decide to charge for each plan.

Tax counsel has advised that the IRS is currently taking approximately 12 months to issue a Private Letter Ruling. The request to the IRS for a Private Letter Ruling will be drafted and submitted by tax counsel.

Alternative option

An alternative option to seeking IRS approval is to work with tax counsel to determine if the survivor option reelection law can be amended so that there are no longer plan qualification issues. LEOFF Plan 2 staff and DRS requested tax counsel to research this possibility. Tax counsel recommended that in order to comply with the re-annuitization and nonincreasing annuity treasury regulations a member could not commence their benefit until the benefit calculation has been finalized. This would allow the member more certainty about their benefit prior to making their survivor option election. However, it would delay the member receiving a retirement benefit.

What is a survivor option?

LEOFF Plan 2 members may elect to take a reduction in their monthly benefit in order to leave an ongoing benefit to a survivor. The survivor will receive the ongoing benefit for their lifetime. This feature of LEOFF Plan 2 is referred to as a survivor benefit option. The member must make this election when they apply for retirement. There are four options for a survivor benefit:

1. **Single Life** - This option pays the highest monthly amount of the four choices, but it only lasts for the member’s lifetime. No one will receive an ongoing benefit after the retiree dies. If the retiree dies before the benefit they have received equals their

contributions plus interest (as of the date of their retirement), the difference will be paid in a lump sum to the retirees designated beneficiary.

2. **<u>Joint and 100% Survivor</u>** – The retiree's monthly benefit under this option is less than the Single Life Option. But after the retiree's death, the retiree's survivor will receive the same benefit the retiree was receiving during his or her lifetime.
3. **<u>Joint and 50% Survivor</u>** – This option applies a smaller reduction to the retiree's monthly benefit than option 2. After the retiree's death, the retiree's survivor will receive half the benefit the retiree was receiving during his or her lifetime.
4. **<u>Joint and 66.67% Survivor</u>** – This option applies a smaller reduction to the retiree's benefit than option 2 and a larger reduction than option 3. After the retiree's death, the retiree's survivor will receive 66.67% of the benefit the retiree was receiving during his or her lifetime.

The survivor is typically a spouse, but can be someone else. If a member is married they are required to get spousal consent to choose an option other than option 3.

What are the survivor options for other retirement plans?

Plans 1, 2, and 3 in PERS, SERS, and TRS all have the same survivor benefit options as LEOFF Plan 2. LEOFF 1 has an automatic joint and 100% survivor benefit. In LEOFF 1 the member does not take a reduction in their benefit to leave this survivor benefit.

How much of a reduction in benefit will a member take to leave a survivor benefit?

The amount of the reduction in benefit a member takes when selecting a survivor option benefit is based on administrative factors. These factors are recommended by the Office of the State Actuary and adopted by the LEOFF Plan 2 Board. The factors are based on various actuarial assumptions and assembled into a table categorized by the difference in age between the retiree and their survivor. If the survivor is younger than the retiree the reduction in benefit will be greater. If the survivor is older than the retiree there is still a reduction in benefit; however, the reduction will be less. The intent of these factors is to make the amount of pension funds paid over a single life (survivor option 1) equal to the amount of pension funds paid over two lives (survivor option 2, 3, or 4).

Can a member change their decision to leave, or not leave, a survivor benefit?

A retiree's survivor option choice is irrevocable unless the following occur:

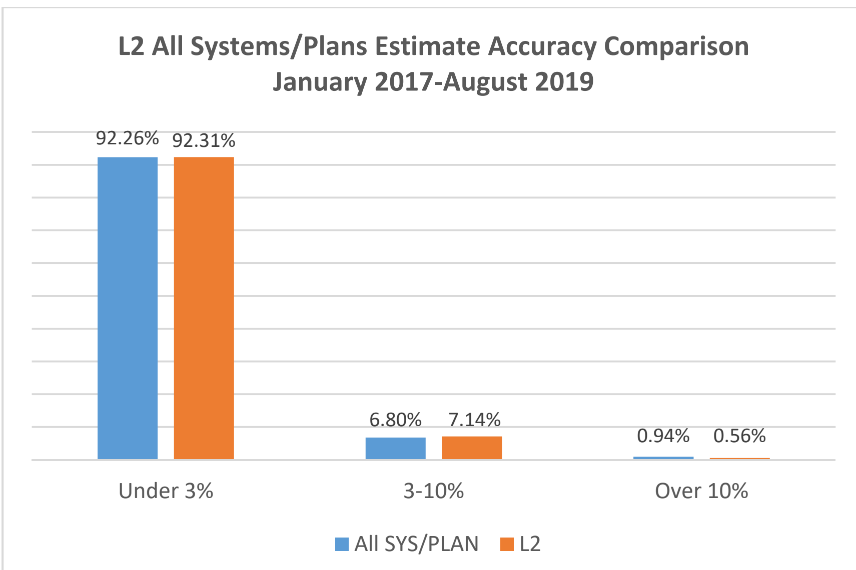
1. They designated someone other than their spouse to receive their survivor benefit. The non-spouse survivor can be removed (option 1) only.
2. They marry or remarry after retirement. To qualify, they must request the change between their first and second years of marriage.
3. They chose a survivor option, and their survivor dies before they do. Their benefit is adjusted to option 1.
4. They return to membership. If they go back to work for any period of time as a contributing retirement plan member, they can retire again and select a new benefit option and/or survivor.

a. PERS members must return to work for two years before they are able to re-retire and change their survivor option.

How does a member know what their benefit will be prior to retiring?
Members are encouraged by the DRS to request an estimate of their retirement benefit, within a year of when they plan to retire. If a member does not request an estimate, DRS still ensures they receive an estimate of their benefit before retiring. When members make their request, they may select multiple estimates based on different survivor options. In addition to what survivor option the member selects, the estimate is calculated based on multiple assumptions, including how long the member will continue to work and what their Final Average Salary will be.

How accurate are benefit estimates?
DRS tracks the accuracy of estimates as part of their ongoing performance metrics. From January 2017 to August 2019 there were 1,261 LEOFF Plan 2 retirements. Of those retirements:

- 1,164 (92.31%) estimates were within 3% of the member's actual benefit;
- 90 (7.14%) estimates were between 3% and 10% of the member's actual benefit; and
- 7 (.56%) were more than 10% different than the member's actual benefit.



There are many reasons an estimate could be different than a member's actual benefit. However, according to DRS, the most common reasons for an estimate to be more than 10% different than the actual benefit are when the member chooses a different retirement date or chooses a different survivor option than they requested for the estimate.

SUPPORTING INFORMATION

Appendix A: Ice Miller Legal Advice Memo

IceMiller
LEGAL COUNSEL

PRIVILEGED AND CONFIDENTIAL MEMORANDUM

TO: **Johnna Craig (DRS) and Steve Nelsen (LEOFF)**

FROM: **Audra Ferguson-Allen and Robert L. Gauss, Ice Miller LLP**

DATE: **September 3, 2020**

RE: **SB 6417**

This Memorandum is provided in confidence and subject to the attorney-client privilege. We have not provided copies to anyone other than the individuals named above. To preserve the attorney-client privilege, you should disclose the contents of this Memorandum only to persons making decisions on the matters discussed herein.

Please allow this memorandum to follow-up on our teleconference on August 13, 2020. Specifically, you asked us to provide an analysis of SB 6417 and the relevant federal tax law in order to consider whether new retirees can be offered an opportunity to change their selected form of benefit. As set forth in more detail below, SB 6417 does not comply with federal law because the ability to change a beneficiary after the benefit has commenced is more expansive than would otherwise be allowed under federal law. Accordingly, we are recommending possible changes to SB 6417 for your consideration.

I. <u>SUMMARY OF SB 6417</u>

SB 6417 amends RCW 41.26.460 as follows:

> (6) Retirees have up to ninety calendar days after the receipt of their first retirement allowance to change their survivor election under subsections (1) and (2) of this section. If a member changes the member's survivor election under this subsection the change is effective the first of the following month and is prospective only.

II. <u>FEDERAL LAW ANALYSIS</u>

As set forth in more detail below, the ability to change beneficiaries and payment options after retirement and commencement of an annuity raises two considerations under federal law. First, Treasury Regulation Section 1.401(a)(9)-6, Q&A-13(a) provides that an annuity payment period only may be changed (also referred to as a "re-annuitization") in association with an annuity increase under Q&A-14 or in accordance with the options provided in Q&A-13(b).
Second, Treasury Regulation Section 1.401(a)(9)-6, Q&A-14 prohibits increasing annuity payments except in certain circumstances.[1]

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[1] Treas. Reg. § 1.401(a)(9)-1, Q&A-2 provides that "a governmental plan . . . is treated as having complied with [Code] section 401(a)(9) . . . if the plan complied with a reasonable and good faith interpretation of [Code] section 401(a)(9)." *See also* PLR 200807023

The Code Section 401(a)(9) Regulations provide as follows:

> In order to satisfy section 401(a)(9), except as otherwise provided in this section, distributions of the employee's entire interest under a defined benefit plan must be paid in the form of periodic annuity payments for the employee's life (or the joint lives of the employee and beneficiary) or over a period certain that does not exceed the maximum length of the period certain determined in accordance with A-3 of this section. The interval between payments for the annuity must be uniform over the entire distribution period and must not exceed one year. <u>Once payments have commenced over a period, the period may only be changed in accordance with A-13 of this section</u>. Life (or joint and survivor) annuity payments must satisfy the minimum distribution incidental benefit requirements of A-2 of this section. <u>Except as otherwise provided in this section (such as permitted increases described in A-14 of this section), all payments (whether paid over an employee's life, joint lives, or a period certain) also must be nonincreasing</u>.

Treas. Reg. § 1.401(a)(9)-6, Q&A-14(a) (emphasis added).

Because the Treasury Regulations provide that, under a lifetime annuity paid from a defined benefit plan, the member's annuity starting date must be treated as the required beginning date, these prohibitions apply once the member has commenced benefits, regardless of the member's age at commencement. Treas. Reg. § 1.401(a)(9)-6, Q&A-10.

<u>Treas. Reg. § 1.401(a)(9)-6, Q&A-13: Annuity Period Changes ("Re-Annuitization")</u>

In order for the annuity payment to be changed, the stream of annuity payments must otherwise satisfy Code § 401(a)(9) and the modification must not cause the distributions to fail to satisfy Code § 401(a)(9). Treas. Reg. § 1.401(a)(9)-6, Q&A-13(b). In order for an annuity payment to be changed, either:

- The modification occurs at the time the employee retires or in connection with a plan termination;

- The annuity payments prior to the modification are annuity payments paid over a period certain without life contingencies; or

- <u>The annuity payments after modification are paid under a qualified joint and survivor annuity over the joint lives of the employee and a designated beneficiary, the employee's spouse is the sole designated beneficiary, and the modification occurs in connection with the employee being married to such spouse</u>.

Treas. Reg. § 1.401(a)(9)-6, Q&A-13(b) (emphasis added). With respect to the third exception to the prohibition against changing the period of the benefit, the new spouse must be the "sole designated beneficiary" under the new benefit:

> If, in a stream of annuity payments that otherwise satisfies section 401(a)(9), the annuity payment period is changed and the annuity payments are modified in association with that change, this modification will not cause the distributions to fail to satisfy section 401(a)(9) provided the conditions set forth in paragraph (c) of this A-13 are satisfied, and … (3) the annuity payments after modification are paid under a qualified joint and survivor annuity over the joint lives of the employee and a designated beneficiary, the employee's spouse is the sole designated beneficiary, and the modification occurs in connection with the employee becoming married to such spouse.

Treas. Reg. § 1.401(a)(9)-6, Q&A-13(b)(3).

If changes are allowed, in order to modify a stream of annuity payments, the following conditions must be satisfied:

- The future payments under the modified stream satisfy Code § 401(a)(9) and Treas. Reg. § 1.401(a)(9)-6 (determined by treating the date of the change as a new annuity starting date and the actuarial present value of the remaining payments prior to the modification is the entire interest of the participant);

- For purposes of Code § 415, the modification is treated as a new annuity starting date;

- After taking into account the modification, the annuity stream satisfies Code § 415 (determined at the original annuity starting date, using the interest rates and mortality tables applicable to such date); and

- The end point of the period certain, if any, for the modified payment period is not later than the end point available under Code § 401(a)(9) to the employee at the original annuity starting date.

Treas. Reg. § 1.401(a)(9)-6, Q&A-13(c).

Thus, upon re-annuitization, the value of the entire benefit cannot be increased by the re-annuitization. Instead, the re-annuitization date must be established as a new annuity starting date and the requirements of Code Section 401(a)(9) and 415 are applied to the newly computed benefit.

<u>Treas. Reg. § 1.401(a)(9)-6, Q&A-14: Nonincreasing Annuity</u>

With respect to the prohibition against increasing annuity payments after commencement of the benefit, Treas. Reg. § 1.401(a)(9)-6, Q&A-14, provides several exceptions, generally including:

- An annual percentage increase under an approved cost-of-living adjustment (COLA);

- A percentage increase at certain specified times which does not exceed an approved COLA;

- A "pop-up" benefit increase if a beneficiary either dies or is no longer a beneficiary under a QDRO, to the extent the benefit was reduced to provide the survivor benefit;

- A plan amendment;

- A beneficiary's conversion of a survivor benefit to a lump sum distribution at the employee's death;

- A constant percentage increase less than 5%, occurring at least annually;

- A final payment of any remaining employee contributions or accrued benefit; and

- Certain dividend payments.

Treas. Reg. § 1.401(a)(9)-6, Q&A-14 (emphasis added).

The exception above which permits a "pop-up" benefit increase if a beneficiary either dies or is no longer a beneficiary under a QDRO is specifically limited to those circumstances—i.e., there is no exception in a situation where a retirant would be changing beneficiaries outside those parameters.[2]

III. APPLICATION OF FEDERAL LAW TO SB 6417

As set forth in more detail below, the provisions of SB 6417 allowing a retiree up to ninety (90) calendar days after receiving his/her first retirement allowance to change the survivor election does not comply with the federal law restrictions regarding when an annuity period may be changed or when an annuity payment may be increased.

A. Potential Violation of Re-Annuitization Treasury Regulations

As noted above, a pension is re-annuitized if the pension payment period is changed. If a LEOFF or DRS retiree changes his/her designated beneficiary, that would in almost all cases be a change in the pension payment and amount.

As noted above, the Treasury Regulations restrict the ability to re-annuitize a pension after payments have commenced. Thus, unless the re-annuitization occurs in association with an

[2] We would note that, based on the provisions of Treas. Reg. § 1.401(a)(9)-8, Q&A-6, we think that, assuming LEOFF or DRS recognize QDROs post-benefit commencement, it may be permissible to add a beneficiary if directed under a QDRO even after annuity payments have commenced (presumably decreasing the member's benefit). While it may be argued that such a change would violate the prohibition against changing the period of the benefit, it seems reasonable to take the position that, while not specified as an exception under Treas. Reg. § 1.401(a)(9)-6, Q&A-13, it is contemplated by Treas. Reg. § 1.401(a)(9)-8, Q&A-6.

annuity increase under Q&A-14 (discussed below), then LEOFF or DRS only would be allowed to re-annuitize a lifetime annuity if the re-annuitization was in connection with a marriage and the retiree's spouse is the sole designated beneficiary.

B. <u>Potential Violation of Nonincreasing Annuity Treasury Regulations</u>

As stated above, if beneficiary dies or is no longer a beneficiary under a QDRO, a joint and survivor annuity may "pop-up" to a single life annuity. However, there is no exception which would allow a retiree to change his or her benefit for any other reason outside of death of a beneficiary or QDRO. In addition, naming a new beneficiary, other than for a remarriage as discussed above in III.A, will result in an impermissible re-annuitization.

Further, we do not think this can be classified as a permissible increase based on a "plan amendment." The plan amendment exception focuses on increases in <u>payment</u> due to a plan amendment. It is not intended to encompass the prohibitions otherwise in place regarding changing beneficiaries and plan options post-retirement.

IV. <u>CONCLUSION</u>

We recommend amending SB 6417 to limit the changes to those permissible under the Treasury Regulations. For instance, a change is permissible if the member names his/her spouse as a survivor beneficiary, but the spouse is no longer the member's spouse due to divorce or other judicial decree. Otherwise, in order to comply with the requirements under Treas. Reg. 1.401(a)(9)-6, our recommendation would be that a member either (a) not commence his/her benefit until the benefit calculation has been finalized or (b) not be allowed an opportunity to change their form of benefit election.

Of course, if you would like to schedule a follow-up teleconference to discuss this Memorandum, please do not hesitate to let us know.

LEOFF
Plan 2 Retirement Board

Survivor Reelection

Initial Presentation
September 23, 2020

Issue

- Allowing members to change their survivor option election after retirement may raise plan qualification issues with the IRS

Legislative Background

- The LEOFF 2 Board endorsed legislation to allow LEOFF 2 retirees up to 90 calendar days after the receipt of their first retirement allowance to prospectively change their survivor election
  - The bill was amended to include all DRS covered retirement plans
- Tax counsel identified possible plan qualification issues with the bill
  - The bill was amended to not take effect until the state received determination from the IRS that these changes conform to federal law. The amended bill passed and was signed into law

Plan Qualification Issues

- Re-annuitization treasury regulations
  - Restricts the ability to re-annuitize a pension after payments have started
- Nonincreasing annuity treasury regulations
  - Upon re-annuitization, the value of the entire benefit cannot be increased by the re-annuitization, except under limited exceptions

IRS Determination

- LEOFF 2 Board staff are working with DRS and tax counsel on next steps
- Tax counsel has advised that the type of determination from the IRS that we should seek is a Private Letter Ruling
- Seeking one Private Letter Ruling for all DRS systems/plans

Alternative option

- A member could delay receiving their benefit until the benefit calculation has been finalized by DRS
  - This would allow the member more certainty about their benefit amount prior to making their survivor option election
  - However, it would delay the member receiving a retirement benefit

Next Steps

- LEOFF 2 Board staff will continue to work with DRS and tax counsel to explore alternative options and to submit a request for Private Letter Ruling to the IRS

Thank You

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