

INITIAL CONSIDERATION

By Jacob White

Senior Research & Policy Manager

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ISSUE

Members are not able to change their survivor option, beyond 90 days from their first retirement payment, even if a post-retirement recalculation causes a change in their pension.

OVERVIEW

This report will provide information on the irrevocable election of a member's survivor options and why they are typically irrevocable. It will also explain why retirement benefits may be recalculated and the impacts to members of a recalculation of their benefit.

BACKGROUND AND POLICY ISSUES

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 retiree's designated beneficiary.
2. **Joint and 100% Survivor** – 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. **Joint and 50% Survivor** – 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. **Joint and 66.67% Survivor** – 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 survivor benefit election?

In 2020 the Board endorsed SB 6417, which allowed retirees to have a 90-day window after the receipt of their first retirement payment to change their survivor election. This bill was signed into law and has been in effect since June 2020.

Can a member's benefit change after retirement?

When DRS receives additional information about an employee's Final Average Salary or service credit they are required under RCW 41.50.130 to recalculate the retiree's retirement benefit. This is referred to as a "recalc". Current law does not allow a member to change their survivor option after a recalc. A recalc may result in either an increase or a decrease to a member's benefit. The recalc is both retrospective and prospective. Therefore, in addition to the change in retirement benefit moving forward, DRS must pay the retiree an additional payment or collect from the retiree the difference in the pension payments they have received and the recalculated benefit amount they should have received.

DRS prioritizes recalcs that are a result of an audit finding, as those are most likely to have the largest impacts on members. However, DRS does not audit employers on a regular basis. In fact, there are some employers who have never been audited by DRS.

When a recalc occurs and a member's benefit is lowered, the member may also owe DRS an overpayment for the pension benefits they were incorrectly paid. The determination of whether the member or employer must pay the overpayment is governed by RCW 41.50.130 – 139. Typically, employers are only required to pay back the overpayment in the following situations:

- Failure to properly report retiree return to work hours¹; and,
- Erroneously reporting that an employee has separated from service.²

There is a statute of limitations of three years, under RCW 41.50.130. Under this statute of limitations, DRS can only bill the member for three years of overpayments from the discovery of the overpayment. For example, if on January 1, 2022, DRS discovered that a retiree received 10 years of overpayments. These overpayments total \$10,000, \$1,000 a year. DRS cannot collect the full \$10,000. Instead, they may only collect \$3,000, for the last three years of overpayments.

In most instances, the member is responsible for paying back the overpayment. This includes overpayments for an employer misreporting earnable compensation to DRS. The Director of DRS, in certain instances, may waive the collection of an overpayment under RCW 41.50.138. However, this is limited to instances of “manifest injustice”.

DRS has not defined the term “manifest injustice” in WAC or in administrative policy. Generally, “manifest injustice” is used in criminal proceedings and “means something which is 'obviously unfair' or 'shocking to the conscience.' It refers to an unfairness that is direct, obvious, and observable.”³

While, the term is common in criminal law, it is also used in administrative law. For example, the Washington State Department of Social and Health Services (DSHS) uses the “manifest injustice” standard as an element of multi-factor test for waiving collection of certain client overpayments. DSHS has defined the term as:

The overpayment is clearly unfair to the client based on the way that it occurred and repayment would compromise the client's ability to meet basic needs.

Factors which can be used as evidence [...]:

The client cannot repay the overpayment without drawing on funds needed for basic requirements. Document income and expenditures. Verify only questionable amounts.

It is clear that the client acted in good faith by following the rules required to maintain eligibility for public assistance.

- a) The client reported income timely and accurately
- b) The overpayment was solely due to department error; and

¹ RCW 41.50.139

² RCW 41.50.139

³ <https://definitions.uslegal.com/m/manifest-injustice/#:~:text=Manifest%20injustice%20means%20something%20which,direct%2C%20obvious%2C%20and%20observable.>

c) The client has "clean hands". That is, without fault. The client fulfilled all their responsibility to inform the department of changes in their circumstances.⁴

Why is the decision to change a survivor benefit irrevocable beyond 90 days when there has been a recalculation?

The decision to leave a survivor benefit is in part irrevocable because it helps mitigate the risk of anti-selection. Anti-selection is the tendency of a person to recognize his or her health status in selecting the option under a retirement system which is most favorable to him or herself. If anti-selection risks are not effectively mitigated, it can increase the costs of the retirement system.

Since the survivor option administrative factors are based on average life expectancies, rather than individual life expectancies, the potential impact of anti-selection on LEOFF Plan 2 would be members could "game the system" to their advantage and the detriment of LEOFF Plan 2. For example, if a member is aware they have a terminal disease, they could choose to leave a larger survivor benefit than they would have selected if not for their knowledge of their terminal disease.

Anti-selection may impact members through either increased contribution rates and/or less favorable administrative factors for survivor options. Since contributions into LEOFF Plan 2 are paid by both employers and members, the impact of anti-selection risks are paid for by both. If a change in policy increased anti-selection risks to the point of impacting contribution rates, this would likely result in intergenerational inequity because the benefit being utilized by recent retirees would be funded by active members.

How does LEOFF Plan 2 mitigate the anti-selection risks of survivor benefits?

Currently, the impact of anti-selection on LEOFF Plan 2 is minimized by requiring members to make an irrevocable survivor option election at the time of retirement. The more opportunity a member has to make or change that election, the more likely anti-selection risks to LEOFF Plan 2 will increase.

The risk of anti-selection is minimized in the post-retirement marriage survivor option provision by requiring the member to make the election after they have been married for a year, but prior to the second year of marriage. This helps mitigate the risk that a retiree finds out they have a terminal disease and decides to marry for the purpose of leaving a survivor benefit.

The requirement that the retiree make this decision prior to the second year of marriage further mitigates anti-selection risk by ensuring they do not prolong the decision until they become aware of additional information, such as a terminal disease.

⁴ <https://www.dshs.wa.gov/book/export/html/21>

Are there Federal Tax Law issues with allowing members to change their survivor option beyond 90 days when a recalculation of their benefit has occurred?

SB 6417 (2020) was amended during session to require a determination from the IRS that the changes to the law conformed with federal law before the bill could take effect. DRS received a determination (See Appendix A) from the IRS that the bill conformed with federal law and has implemented the legislation. The IRS determination was limited to the specific language of SB 6417. Therefore, the Board may want to seek determination from the IRS for an additional opportunity for a member to change their survivor option.

SUPPORTING INFORMATION

Appendix A: IRS Private Letter Ruling re SB 6417(2020)

APPENDIX A

INTERNAL REVENUE SERVICE



FAX TRANSMISSION Cover Sheet

Date: August 05, 2021

To: Robert Gauss

Address/Organization: Ice Miller LLP

Fax Number: 317-592-4668 Office Number: _____

From: Brandon Ford

Address/Organization: CC: EE:EB:QP4

Fax Number: _____ Office Number: _____

Number of pages: *Including cover page*

Subject: PLR-102960-21

This communication is intended for the sole use of the individual to whom it is addressed and may contain confidential information that is privileged, confidential and exempt from disclosure under applicable law. If you are not the intended recipient, you are hereby notified that any dissemination, distribution or copying of this communication is strictly prohibited by the provisions of the Internal Revenue code. If you have received this communication in error, please contact the sender immediately by telephone. Thank you.

Internal Revenue Service**Department of the Treasury**

Washington, DC 20224

Index Number: 401.06-00

Third Party Communication: None
Date of Communication: Not ApplicableWashington Department of Retirement
Systems

ATTN: Johnna Craig

P.O. Box 48380

Olympia, WA 98504-8380

Person To Contact:

Brandon Ford, ID No. 1003343965

Telephone Number:

(202) 317-4671

Refer Reply To:

CC:EEE:EB:QP4

PLR-102960-21

In Re: Washington Department of Retirement
Systems

Date:

August 03, 2021

Legend

State X = State of Washington
Plan Administrator Y = Washington Department of Retirement Systems
Bill Z = Washington Senate Bill 6417

Dear Ms. Craig:

This is in response to your letter dated February 1, 2021, and subsequent correspondence dated June 18, 2021, submitted on your behalf by your authorized representative, in which you request a ruling under § 401(a)(9) of the Internal Revenue Code.

The following facts and representations have been submitted under penalties of perjury in support of the rulings requested:

Plan Administrator Y administers retirement plans that are sponsored by State X on behalf of employees of State X. This ruling request involves eight defined benefit plans. Distributions under the plans are required to begin no later than the required beginning date (as that term is defined in § 401(a)(9)(C)). The laws of State X require that unless distributed in a lump sum, a participant's entire interest in any of the plans must be distributed over the participant's life or the lives of the member and a designated beneficiary, or over a period not extending beyond the life expectancy of the participant or of the participant and a designated beneficiary.

Participants in the plans may select one of the following four survivorship benefits upon their retirement: (1) Joint and 100%, a full survivorship benefit; (2) Joint and 66.67%, a two-thirds survivorship benefit; (3) Joint and 50%, a one-half survivorship benefit; and

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(4) Single Life, with no survivorship benefit. Currently, a participant's survivorship benefit election is irrevocable.

Plan Administrator Y provides benefit estimates to participants in the plans before their retirement. Estimates may differ from the actual benefits paid to a participant due to the actual retirement date or survivorship option being different from that used to calculate the estimate. In some cases, Plan Administrator Y receives additional salary information after the participant has retired but before the finalization of the benefit amount resulting in a final benefit amount different than the benefit estimate.

When Plan Administrator Y receives additional information about a participant's compensation or service credit, the laws of State X require Plan Administrator Y to recalculate the benefit amount. In most cases, the recalculation is finalized shortly after the participant's retirement.

State X enacted Bill Z in 2020 allowing participants in any of the plans up to 90 calendar days after the receipt of their first monthly retirement allowance to prospectively change their survivorship benefit election. If a participant changes the survivorship election, the change is effective the first day of the following month. The provisions of Bill Z become effective following the receipt of a favorable private letter ruling from the Internal Revenue Service that the limited ability to change a survivorship benefit election during the 90-day window conforms with federal law.

Based on the foregoing facts and representations, you have requested a ruling that the minimum distribution requirements of § 401(a)(9) are not violated due to Bill Z, which allows current and future participants in the eight affected defined benefit plans administered by Plan Administrator Y to change their survivor option election within 90 days after receipt of their first retirement allowance.

Law

Section 414(d) provides that the term "governmental plan" means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.

Section 401(a)(9)(A) provides, in general, that a trust will not be considered qualified unless the plan provides that the entire interest of each employee (i) will be distributed to such employee not later than the required beginning date, or (ii) will be distributed, beginning not later than the required beginning date, over the life of such employee or over the lives of such employee and a designated beneficiary or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary.

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Section 1.401(a)(9)-1, Q&A-2(d) of the Income Tax Regulations provides that a governmental plan (within the meaning of section 414(d)) is treated as having complied with § 401(a)(9) for all years to which § 401(a)(9) applies to the plan if the plan complies with a reasonable and good faith interpretation of § 401(a)(9).

Ruling

In the present case, you have represented that the plans established and maintained by State X on behalf of certain employees of State X are governmental plans (as defined in § 414(d)). Accordingly, those plans are treated as having complied with § 401(a)(9) for all years to which § 401(a)(9) applies to the plan if the plan complies with a reasonable, good faith interpretation of § 401(a)(9).

A participant's option to change the survivorship election within the first 90 days of receiving the first benefit payment does not cause the plans to fail to satisfy the underlying requirements of § 401(a)(9)(A). Thus, the plans comply with a reasonable, good faith interpretation of § 401(a)(9)(A). Accordingly, the minimum distribution requirements of § 401(a)(9) are not violated due to Bill Z, which allows current and future participants in the plans administered by Plan Administrator Y to change their survivorship benefit election within 90 days after receipt of their first retirement allowance.

The rulings contained in this letter are based upon information and representations submitted by your personal representative and accompanied by a penalties of perjury statement executed by an appropriate party, as specified in Rev. Proc. 2021-1, 2021-1 I.R.B. 1, § 7.01(16)(b). This office has not verified any of the material submitted in support of the request for rulings, and such material is subject to verification on examination. The Associate office will revoke or modify a letter ruling and apply the revocation retroactively if there has been a misstatement or omission of controlling facts; the facts at the time of the transaction are materially different from the controlling facts on which the ruling was based; or, in the case of a transaction involving a continuing action or series of actions, the controlling facts change during the course of the transaction. See Rev. Proc. 2021-1, § 11.05.

Except as expressly provided above, no opinion is expressed or implied concerning the federal income tax consequences of any other aspects of any transaction or item of income described in this letter ruling.

This letter is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Laura B.

Warshawsky

Digitally signed by
Laura B. Warshawsky
Date: 2021.08.04
16:28:34 -04'00'

Laura B. Warshawsky
Branch Chief
Qualified Plans Branch 1
Office of Associate Chief Counsel
(Employee Benefits, Exempt Organizations,
and Employment Taxes)

cc: Robert Gauss, Ice Miller
Audra Ferguson-Allen, Ice Miller
Andrew J. Fedders, EP R&A
Eric San Juan, TEGE

Internal Revenue Service**Department of the Treasury**

Washington, DC 20224

Index Number: 401.06-00

Third Party Communication: None
Date of Communication: Not ApplicablePerson To Contact:
, ID No.

Telephone Number:

In Re:

Refer Reply To:
CC:EEE:EB:QP4
PLR-102960-21Date:
August 03, 2021**Legend**State X =
Plan Administrator Y =
Bill Z =

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In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Laura B. Warshawsky
Branch Chief
Qualified Plans Branch 1
Office of Associate Chief Counsel
(Employee Benefits, Exempt Organizations,
and Employment Taxes)

cc:



Department of the Treasury
Internal Revenue Service

Mailing Date:
08/05/2021
Last date to request IRS review:
08/25/2021
Last date to request delay:
10/04/2021
Last date to petition Tax Court:
10/04/2021
Date open to public inspection:
10/29/2021
Person to contact:
Chief, Disclosure Support Branch
Contact telephone number:
202-317-6840

Notice of Intention to Disclose

In accordance with Section 6110 of the Internal Revenue Code, we intend to make the enclosed copy of your ruling (with deletions) open to public inspection.

Section 6110 provides that copies of certain rulings, technical advice memoranda, and determination letters will be open to public inspection after deletions are made. These written determinations will be open to public inspection online in the Freedom of Information Act (FOIA) Reading Room at www.irs.gov/privacy-disclosure/foia-library.

We made the deletions indicated in accordance with Section 6110(c), which requires us to delete:

1. The names, addresses, and other identifying details of the person the ruling pertains to, and of any other person identified in the ruling [other than a person making a "third party communication" (see back of this notice)].
2. Information specifically authorized under criteria established by an Executive Order to be kept secret in the interest of national defense or foreign policy, and which is in fact properly classified under such Executive Order.
3. Information specifically exempted from disclosure by any statute (other than the Internal Revenue Code) which is applicable to the Internal Revenue Service.
4. Trade secrets and commercial or financial information obtained from a person that are privileged or confidential.
5. Information which would constitute a clearly unwarranted invasion of personal privacy.
6. Information contained in or related to examination, operating, or condition reports prepared by, or for use of, an agency that regulates or supervises financial institutions.
7. Geological and geophysical information and data (including maps) concerning wells.

These are the only grounds for deleting material. We made the indicated proposed deletions after considering any suggestions for deletions you may have made prior to issuance of the ruling.

If you agree with the proposed deletions

You do not need to take any further action. We will place the deleted copy in the online FOIA Reading Room on the "Date open to public inspection" shown on this notice.

If you disagree with the proposed deletions

Please return the copy and show, in brackets, any additional information you believe should be deleted. Include a statement supporting your position. Only material falling within the seven categories listed above may be deleted. Your statement should specify which of these seven categories is applicable with respect to each additional deletion you propose. Mail or fax your deleted copy and statement to:

Internal Revenue Service

Attention: Chief, CC:PA:LPD:DS

Ben Franklin Station

Post Office Box 7604

Washington, DC 20044

Fax: 855-592-8978

It must be faxed or postmarked no later than the "Last date to request IRS review" shown on this notice. We will give your submission careful consideration. If we determine we cannot make any or all of the additional deletions you suggest, we will so advise you not later than 20 days after we receive your submission. You will then have the right to file a petition in the United States Tax Court if you disagree with us. Your petition must be filed no later than the "Last date to petition Tax Court" shown on this notice, which is 60 days after the mailing date of this notice. If a petition is filed in the Tax Court, the disputed portion(s) of the ruling will not be placed in the Reading Room until after a court decision becomes final.

If no petition is filed in the Tax Court, the deleted copy of your ruling will be made open to public inspection on the date shown on this notice. If the transaction to which the ruling relates will not be completed by then, you may request a delay of public inspection.

Request for delay of public inspection

You may request a delay of public inspection of up to 90 days, or 15 days after the transaction is completed, whichever is later. The request for delay must be received by the IRS no later than the "Last date to request delay" shown on this notice, which is 60 days after the mailing date of this notice. Mail or fax your request for delay to:

Internal Revenue Service

Attention: Chief, CC:PA:LPD: DS

Ben Franklin Station

Post Office Box 7604

Washington, DC 20044

Fax: 855-592-8978

You may request a second delay of up to an additional 180 days (or 15 days after the completion of the transaction, whichever is earlier) if the transaction is not completed by the end of the original delay period and if good cause exists for additional delay. We must receive a request for a second delay at the above address at least 30 days before the original delay period ends.

Requests for additional disclosure

After the copy of your ruling, with deletions, is placed in our online FOIA Reading Room, any person may request us to make additional portions of the ruling open to public inspection. If we receive a request that involves disclosure of names, addresses, or taxpayer identifying numbers, we will deny the request and you will not be contacted. If that request involves disclosure of anything other than names, addresses, or taxpayer identifying numbers, we will contact you before taking action.

Third party communication

The enclosed copy of your ruling may contain the notation "Third Party Communication." This indicates that IRS received a communication (written or oral) regarding your ruling request from a person outside the IRS (other than you or your authorized representative). The date of the communication and the category of the person making the contact (such as "Congressional" or "Trade Association") will be indicated.

If you have any questions regarding this notice, please call us at 202-317-6840.



Survivor Option Reelection

Initial Consideration

May 18, 2022

Issue

- **Members are not able to change their survivor option, beyond 90 days from their first retirement payment, even if a post-retirement recalculation causes a change in their pension**

Post-Retirement Recalculations

- When DRS receives additional information about an employee's Final Average Salary or Service Credit they recalculate (aka recalc) the retiree's retirement benefit
- Current law does not allow a member to change their survivor option after a recalc

Overpayment Responsibility

- **Member Responsibility**
 - Typically, for reportable compensation errors
- **Employer Responsibility**
 - Typically, for retirement status and separation from service errors
 - More of an issue with other plans because of their retiree return to work rules
 - Employer must verify retirement status at the time of hire

Statue of limitations

- **DRS can only bill the member for 3 years of overpayments from the discovery of the overpayment**
 - **Example - On January 1, 2022, DRS discovered that a retiree received 10 years of overpayments. These overpayments total \$10,000, \$1,000 a year. DRS cannot collect the full \$10,000. Instead, they may only collect \$3,000, for the last 3 years of overpayments**

Repayment Options

- **Lump Sum Payment – 90 days to make full lump sum payment**
- **Installment Plan – Make installment payments through a reduction in pension for a limited number of months**
- **Actuarial Reduction – Pension is actuarially reduced by an amount equal to the overpayment**

Waiver of Overpayments

- DRS Director may waive overpayments, if:
 - The overpayment was not the result of the retiree's or the beneficiary's nondisclosure, fraud, misrepresentation, or other fault; and
 - The Director finds that recovery of the overpayment would be a manifest injustice
- “Manifest injustice” has not been defined by DRS
 - General definition is that it means something which is 'obviously unfair' or 'shocking to the conscience.' It refers to an unfairness that is direct, obvious, and observable

Potential Tax Law Concerns

- **IRS approved of 90-day window to change survivor option**
- **IRS was not asked whether a window beyond the 90-day window would be allowed**
- **Staff requires Board approval to pay for legal advice from Tax Counsel**

Anti-Selection Risk

- Anti-selection is the tendency of a person to recognize his or her health status in selecting the option under a retirement system which is most favorable to him or herself
- The decision to leave a survivor benefit is in part irrevocable because it helps mitigate the risk of anti-selection
- Anti-selection may impact members through increased contribution rates and/or less favorable administrative factors for survivor options
 - Increase risk of Intergenerational inequity

Possible Board Action

1. Authorize Board staff to seek legal advice from tax counsel regarding retiree's ability to change survivor option when a recalculation of their benefit has occurred
2. No action today

Next Steps

- **Comprehensive Report scheduled for April Board Meeting**



Thank You

Jacob White

Senior Research and Policy Manager

(360) 586-2327

jacob.white@leoff.wa.gov