NEW IRS REGULATION PROVIDES RELIEF FROM LUMP SUM PAYMENTS FOR DISTRESSED SINGLE-EMPLOYER PENSION PLANS

The Internal Revenue Service has finalized an amendment to Treasury Regulation Section 1.411(d)-4, that, effective November 8, 2012, allows certain companies to eliminate a "lump sum" distribution option under a single-employer pension plan. The new regulation will provide some relief to companies, such as AMR Corp. ("AMR"), the parent of American Airlines, Inc., currently in bankruptcy, that have significant unfunded pension obligations. Eligible companies must still pay accrued pension benefits in full; however, a participant cannot retire and elect to receive his or her pension benefit in a single lump sum form of payment.

Section 411(d)(6) of the Internal Revenue Code (the "Code") generally provides that a tax-qualified retirement plan (*e.g.*, a 401(k), profit sharing or pension plan) may not decrease previously accrued benefits of participants by plan amendment. Eliminating an optional form of payment with respect to benefits attributable to service before the amendment is treated as impermissibly reducing a participant's accrued benefit in violation of the Code's "anti-cutback" rule. In effect, absent an exception, such as the one provided under the new regulation, Section 411(d)(6) of the Code would bar AMR from denying a lump sum payout to a participant if the participant had already earned the right to receive such payment, which could significantly hinder AMR's financial recovery following its emergence from bankruptcy.

In granting the exception, the IRS noted that its authority under Section 411(d)(6) of the Code to allow employers to retroactively eliminate optional forms of payment is available only under very limited circumstances. According to the legislative history, the exercise of such authority should be limited to circumstances where the optional form of payment does not relate to a valuable right of a plan participant or beneficiary and the option is not subsidized.[1] While recognizing the enhanced value of a lump sum payment option to a participant with a substandard life expectancy, the IRS reasoned that if the amendment to eliminate the lump sum option were not allowed, there would be a substantial likelihood that an employer involved in a bankruptcy proceeding, such as AMR, would terminate its pension plan in a distress termination proceeding permitted under Section 4041(c) of the Employee Retirement Income Security Act ("ERISA") prior to emerging from bankruptcy. When a single-employer pension plan is terminated in a distress termination and plan assets are not sufficient to provide all guaranteed benefits (which is often the case), the Pension Benefit Guaranty Corporation (the "PBGC") takes over the plan, but the government will pay benefits only up to specified limits and in a form of payment that does not generally include a lump sum option. Therefore, in granting employers such as AMR the ability to eliminate a lump sum payment option in plans that are continued after an employer emerges from bankruptcy, participants will be able to receive full retirement

[1] S. Rep. No. 98-575, at 30 (1984).

benefits, rather than the PBGC's limited benefit, of equal actuarial value to the lump sum payment option (based on standard mortality).

In order to eliminate a lump sum option from a single-employer pension plan, the following four conditions must be satisfied on the later of the date the amendment is adopted or the date it is made effective:

- **Actuarial Certification:** The enrolled actuary for the pension plan must certify that the plan's adjusted funding target attainment percentage (in general, the value of plan assets relative to plan liabilities) is less than 100 percent for the plan year that contains the applicable amendment date.

- **Sponsor in Bankruptcy:** The plan sponsor must be a debtor in a bankruptcy case *(i.e.,* a case under Title 11 of the U.S. Code or a similar federal or state law) and therefore be prohibited from making lump sum payments during the bankruptcy proceedings due to the application of the requirements of Section 436(d)(2) of the Code and Section 206(g)(3)(B) of ERISA.

- **Bankruptcy Court Approval:** The court overseeing the bankruptcy case must issue an order, after notice to affected parties (*i.e.*, plan participants and beneficiaries, employee representatives and the PBGC) and a hearing, finding that the amendment eliminating the lump sum payment option is necessary to avoid a distress termination of the plan by the plan sponsor pursuant to Section 4041(c) of ERISA, or an involuntary termination of the plan by the PBGC pursuant to Section 4042 of ERISA, before the plan sponsor emerges from bankruptcy (or before the bankruptcy case is otherwise completed).

- **PBGC Determination:** The PBGC must make a determination that the adoption of the amendment eliminating the lump sum payment option is necessary to avoid a distress or involuntary termination of the plan before the plan sponsor emerges from bankruptcy (or before the bankruptcy case is otherwise completed) and that the plan is not sufficient to provide for guaranteed benefits under ERISA.

Prior to the new rule, distressed companies had few options other than to terminate their underfunded pension plans, leaving the government responsible for millions, and sometimes billions, of dollars in unfunded benefits, while participants would often receive less than the full benefit promised by the plan. The new exception crafted by the IRS is a welcome option that seeks to balance the interests of plan participants, employers and the government.

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November 28, 2012

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