Practical Guidance

Liability-Driven Investing and Other De-risking Strategies for Pension Plans

A Practical Guidance® Practice Note by
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This practice note discusses defined benefit plan de-risking techniques that defined benefit plan sponsors can use to manage the volatility inherent in defined benefit plan funding. These techniques include offering lump sums during a window period to terminated vested participants, implementing annuity buy-ins, annuity buy-outs, and adopting a liability driven investment (LDI) strategy. This practice note focuses on the last of these strategies, particularly the fiduciary issues under the Employee Retirement Income Security Act (ERISA) raised by LDI strategies, and suggests best practices to minimize fiduciary risks associated with plan de-risking activities.

The practice note is organized under the following topics:

- Overview of Defined Benefit Plan Risks
- Liability Driven Investing
- Fiduciary Issues Regarding LDI Strategies
- Best Practices When Implementing an LDI Strategy
- Other Strategies to Address Defined Benefit Plan Risk

For related resources, see Freezing Defined Benefit Plan Benefits and Lump Sum Window Programs. For an additional discussion regarding de-risking strategies, see ARTICLE: PENSION DE-RISKING, 93 Wash. U. L. Rev. 733 and Dep't of Labor, Private Sector Pension De-risking and Participant Protections.

Overview of Defined Benefit Plan Risks

Plan sponsors operating tax-qualified defined benefit plans face risks associated with maintaining plan funding levels that are sufficient to pay benefits when due and meet statutory minimum funding requirements, for example under I.R.C. § 412. Each of these risks may affect the plan's funded status, and by extension, the plan sponsor's balance sheet and plan contribution requirements. They include:

- **Business risk.** Business risk identifies the risk of a plan sponsor's pension liabilities becoming disproportionately large relative to the remaining assets of the plan trust (that is, plan liabilities exceed plan assets). This negatively affects the plan's funded status and results in significant financial consequence to the plan sponsor by increasing its funding obligations.
- **Duration risk.** Duration risk identifies the risk associated with the sensitivity of a bond, which is a typical plan investment, to changes in interest rates. Bonds with a longer duration to maturity are more sensitive to interest rate changes, meaning they can lose more value than a short-term bond if bond market interest rates rise.

- **Inflation risk.** This is the risk that cash flows from an investment will be of lower value in the future because of decreased purchasing power due to inflation.
- **Interest rate risk.** This risk recognizes that changes in the interest rate environment will cause significant and unpredictable fluctuations in the plan sponsor's balance sheet obligations, net periodic costs in funding a defined benefit plan, and required plan contributions. When interest rates are lower than their actuarially projected target values, single sum conversion factors for accrued plan benefits rise. This leads to the plan having to pay higher lump-sum benefit payments to retiring participants when converting their life annuities to single sums.
- **Investment risk.** This is the risk that plan asset investments will fail to achieve the expected rate of investment return that the sponsor and plan actuary estimate.
- **Longevity risk.** This is the risk that plan participants and beneficiaries will outlive their life expectancies based on current mortality tables. This causes the plan to pay more to meet its annuity obligations. The risk is difficult to hedge against due to the inherent uncertainty of life expectancies. While individuals can hedge against their own mortality risk by purchasing longevity annuities, plan sponsor hedges require adopting one of the strategies discussed below to effectively hedge against longevity risk. Additionally, plan sponsors must use "reasonable" mortality assumptions based on plan experience in determining minimum funding levels. Since those assumptions are backward-looking, they inherently expose plan sponsors to prospective longevity risk.
- **Market risk**. This is the possibility that the plan experiences losses due to factors that affect the overall performance of the financial markets.

Fruition of any of these risks negatively impacts the plan's funded status and may increase the plan sponsor's funding obligation and its Pension Benefit Guaranty Corporation (PBGC) variable rate premium obligation, if applicable. Each of these risks can negatively impact the plan sponsor's cash flow. Additional plan notice obligations and benefit restrictions may result if the plan becomes significantly underfunded. For a discussion of I.R.C. § 436 requirements, which can lead to a plan placing a limitation on certain forms of payment, required participant notifications, and even suspension of benefit accruals, see Benefit Limitation Rules for Defined Benefit Plans (IRC § 436).

Liability Driven Investing

Liability driven investing, sometimes referred to as liability hedging, is an investment strategy that seeks to mitigate plan funding risks associated with inflation, interest rates, equity volatility, and changes in life expectancy (longevity). Plan fiduciaries, or their investment managers, can address these risks by matching a defined benefit plan's investment among various asset allocations, against the plan's future stream of expected benefit payments. By matching plan assets to the behavior of plan liabilities, the plan sponsor reduces the variability of the plan's funded status and smooths the volatility of the plan's income statement and balance sheet.

As a financial strategy, the LDI concept has been around for decades. Plan sponsors frequently utilized the approach for terminated plans during the period following the termination date, but before benefit distribution, while awaiting final Internal Revenue Service (IRS) and PBGC approvals. While its use waned, it regained popularity with changes to the accounting and funding rules for defined benefit plans, discussed below (see "Accounting Background"). Its application is best suited for frozen plans or those plans for which there is otherwise a significant inactive participant population (i.e., the plan has a significant number of retirees and deferred vested participants who are not in pay status). An LDI strategy is commonly implemented on a tiered basis, with increased emphasis on use of the strategy as the plan's funded percentage increases.

Immunization

An LDI strategy typically involves constructing and enhancing a plan's bond portfolio, applying maturity dates that match the plan's expected benefit payments. This process of funding benefits with matching fixed income securities is known as immunization.

Immunization Objectives

Shifting a plan's asset allocation from equities to bonds in order to immunize benefit liabilities generally reduces a plan's long-term expected investment rate of return. However, since the primary objective of plan sponsors is ensuring that sufficient assets are available to make benefit payments, and not in growing an actuarial surplus in the event of the plan's ultimate termination, reducing future rates of return is an acceptable side effect of immunization as it should improve the predictability of investment returns.

In certain instances, a plan sponsor's election of an immunization strategy will require the sponsor to make a corresponding one-time contribution to the plan, perhaps to improve the plan's current funded status. In doing so, however, the plan sponsor avoids increases in its pension expense as well as in its ongoing plan funding requirements.

Segmentation

Immunization is not limited to the plan's overall benefit liabilities. Instead, an LDI strategy may segment the plan's liabilities according to their estimated duration. The duration gauges how much the liabilities will grow or shrink given a change in interest rates. For example, the plan may immunize its short- or intermediate-length benefit liabilities but continue to invest in equities or alternative investments to fund long-term liabilities. Because interest rates for funding purposes are tied to corporate bond interest rates, high quality corporate bonds with sufficient duration become the best candidate for the portfolio. However, since corporate bonds may not have sufficient duration for a plan's liabilities, for which payments often commence when a participant attains age 65, it's common to also invest plan assets in longer term U.S. Treasury bonds, such as 30-year Treasuries.

Interest Rate Hedging

Even if a plan designs its bond portfolio to immunize some of its benefit liabilities, the plan's other benefit liabilities may rise if interest rates fall. To address this possibility, LDI strategies may hedge against falling interest rates through the purchase of interest rate options and swaps, futures contracts, or other similar financial derivatives. Before approving such sophisticated investment techniques, verify that plan fiduciaries (e.g., the plan investment committee) understand these investment options as an alternative investment strategy. It's best to engage an investment manager to develop and implement the strategy and communicate the same to the investment committee, particularly if the plan's investment policy statement requires committee approval. Amend that statement, too, to reflect the LDI approach that will apply to all or some of the plan's asset portfolio. For a discussion regarding the selection of an investment manager, see Investment Manager Hiring Considerations for ERISA Pension Plans.

Accounting Background

In addition to the accounting required to provide audited financial statements that meet ERISA requirements for Form 5500 annual reports, special pension plan accounting rules apply for public and private entities. ERISA § 103(b) (29 U.S.C. § 1023(b)). Accounting for the costs of a defined benefit pension plan takes into account the plan's assets, accrued liabilities to date, and liabilities to be accrued based on projected future service of active employees and changes in compensation. The resulting liability value is what actuaries and accountants must determine for purposes of presenting the plan's liability (or surplus) for financial disclosure on the plan sponsor's balance sheet. The rules that apply for pension accounting are different from those that apply for plan funding under I.R.C. § 412. For a broader discussion regarding defined benefit plan pension accounting, see Applying GAAP and GAAS § 14.04.

Financial Accounting Standards

Accounting concerns drive many plan sponsors and plan fiduciaries to adopt an LDI approach for their single-employer defined benefit plans. In 1985, the Financial Accounting Standards Board (FASB) issued Statement Number 87 (FAS 87). FAS 87 and FAS 158 (discussed below), along with FASB 88, are now referred to as Accounting Standards Codification Section 715. Also, Accounting Standards Update (ASU) 2018-14, effective for fiscal years ending after December 15, 2020 for public business entities, and fiscal years ending after December 15, 2021, for other entities, requires disclosure of:

- Projected benefit obligations and fair value of plan assets for pension plans with pension benefit obligations in excess of plan assets –and–
- Accumulated benefit obligations and fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets.

Under FAS 87, a plan's funded status was not directly related to the plan sponsor's balance sheet, and disclosure of associated plan liability was only required by footnotes.

FASB Statement Number 158 (FAS 158), issued in 2006, and amended FAS 87, moved the financial information concerning the funded status of a defined benefit pension plan from footnotes to the employer's balance sheet. Its issuance also raised the transparency of the plan sponsor's defined benefit plan funding obligations. As a result, for an underfunded plan, the sponsor's balance sheet now shows pension costs as a liability equal to the difference between the plan's assets and liabilities. This results in a corresponding reduction in the employer's equity.

FAS 158 specifically requires a plan sponsor of one or more defined benefit plans to do the following:

- Recognize the plan's funded status in its statement of financial position, measured as the difference between the fair value of plan assets and the plan's projected benefit obligation (PBO). This is calculated as the present value of expected future payments under the plan, recognizing additional benefits due solely to increases in compensation.

- Recognize plan gains and losses and prior service costs as a component of the plan sponsor's comprehensive income, net of tax, for the accounting period, including credits (if not otherwise recognized under FAS 87 as a component of net periodic benefit cost).
- Measure plan assets and liabilities as of its fiscal year-end statement of financial position.
- Disclose certain effects of pension smoothing on net periodic benefit cost over the next fiscal year in the notes to financial statements that are due to the delayed recognition of plan gains and losses and prior service costs or credits.

Summary of Statement No. 158.

In the second bullet above, FAS 158 introduced a new type of volatility into the balance sheet. It requires employers to recognize changes to the funded status of defined benefit plans as comprehensive income changes in the year that the transition occurs. FAS 87 had instead permitted smoothing the change over time to reduce the volatility in the balance sheet. The impact if greater transparency to shareholders of the negative impact of the plan sponsor's funding obligations in an underfunded plan.

FAS 158 and FAS 87, taken together, have decreased funding certainty for plans, making LDI more attractive to plan sponsors.

International Accounting Standards Board (IASB)

In 2011, the IASB announced changes to "Statement Number 19, Employee Benefits" (IAS 19). The changes took effect on January 1, 2013. The changes were designed to more closely align international accounting standards with FAS 87 and FAS 158. For example, IAS 19, like FAS 158, requires an employer to show the funded status of its defined benefit plan on its balance sheet. Additionally, a plan sponsor's profit and loss statement cannot benefit from investment returns that exceed the assumed discount rate used to measure plan liabilities. Rather, the difference between actual and assumed returns is reflected in other comprehensive income. That disclosure may allow financial statement users to identify the potential impact that these items may have on future profits or losses of the plan sponsor. As with FAS 87 and FAS 158, employers have adopted LDI strategies in response to IAS 19. Note that, while IAS 19 was modified to more closely align with then FAS 158, there still are some significant differences between the two accounting rules.

Pension Protection Act of 2006 (PPA)

Before enactment of the PPA, funding valuation interest rates were usually kept constant from year to year, and the objective of the investment manager was to match or exceed the investment returns of the plan with interest rates used in actuarial valuations. However, discrepancies often existed between standard valuation interest rates and the market valuation associated with plan liabilities. One important change made by the PPA was to require plan actuaries to apply more market-based plan valuation interest rates. As a consequence, pension liabilities became less predictable and there was no longer a clear investment return hurdle for an investment manager to attain.

The PPA also required:

- Shorter smoothing periods for plan assets
- An accelerated period to achieve full funding
- Larger required annual contributions –and–
- Penalties for plans with an unfunded liability

These factors made it more difficult for plan sponsors to hit their funding targets and placed a drain on their cash flows. LDI strategies seek to mitigate some of that difficulty. For a comprehensive discussion regarding minimum funding rules for defined benefit plan and the effect of the PPA on these rules, see Lexis Tax Advisor -- Federal Topical § 1C:12B.02.

American Rescue Plan Act Changes

The American Rescue Plan Act of 2021 (Pub. L. No. 117-2) (ARPA) likely will have a significant effect upon LDI because of two changes that ARPA made to the funding requirements for single-employer defined benefit plans:

- **Extended amortization of plan liabilities.** First, ARPA permanently extended the amortization period for calculating unfunded liabilities to 15 years rather than the 7-year period under the PPA. Pub. L. No. 117-2, § 9705; I.R.C. § 430(c)(8); ERISA § 303(c)(8) (29 U.S.C. § 1083(c)(8)).
- **Interest rate smoothing.** Second, ARPA extended the smoothing rules for interest rates used to calculate pension liabilities. Pub. L. No. 117-2, § 9706; I.R.C. § 430(h)(2)(c)(iv); ERISA § 303(h)(2))(c)(iv) (29 U.S.C. § 1083(h)(2)(c)(iv).

At a minimum, these two changes will likely require plans that have adopted an LDI strategy to consider a new strategy because there will be a longer period of time within which to close the gap between assets and liabilities, and may also accelerate de-risking strategies because of a decrease in near term contributions. While ARPA did not modify the financial accounting requirements for defined benefit pension plans or the termination liability, it is nonetheless likely to have a significant effect on LDI strategies.

Fiduciary Issues Regarding LDI Strategies

Plan fiduciaries must evaluate their ERISA duties of loyalty, avoidance of conflicts of interest, and prudence when adopting and implementing an LDI strategy. While ERISA imposes these duties, the statute and regulations thereunder do not clearly address LDI strategies. Instead, you can counsel plan fiduciaries to rely on Department of Labor (DOL) guidance and applicable court decisions when implementing an LDI strategy. For a discussion regarding a plan fiduciary's general ERISA responsibilities, see ERISA Fiduciary Duties and ERISA Title I Fundamentals. For a discussion regarding an investment manager's ERISA responsibilities, see ERISA Fiduciary Compliance for Investment Managers and Investment Manager Hiring Considerations for ERISA Pension Plans.

ERISA

Duty of Loyalty

Pension plan investment fiduciaries have a duty of loyalty to plan participants and beneficiaries, not to the plan sponsor. LDI strategies inherently benefit the plan sponsor through reduced pension expenses and liability volatility on the employer's financial statements. Accordingly, there is a question whether the fiduciaries are breaching their duty of loyalty when they approve an LDI approach to plan investing.

In this regard, you should direct plan investment fiduciaries to examine carefully a proposed LDI strategy prior to its implementation and to document their decision-making process. This can help ensure that the strategy's implementation fulfills the fiduciaries' duty of loyalty to plan participants and beneficiaries. After a reasonable and impartial inquiry, those fiduciaries may take actions they conclude best promote the interests of participants and beneficiaries, even if those actions benefit the plan sponsor, as well. Thus, if the investment fiduciary determines an LDI strategy is the best means to protect participant and beneficiary interests in the plan, and guard against excessive asset fluctuations, the plan fiduciary can implement the strategy, even if it benefits the plan sponsor's balance sheet.

The Supreme Court's decision in Thole v U.S. Bank, N.A., 140 S. Ct. 1615 (2020) made it significantly more difficult for individual plaintiffs to bring a claim under ERISA for breach of fiduciary duty because of a lack of Article III standing. To establish standing under Article III of the U.S. Constitution, a plaintiff must demonstrate that:

- They suffered an injury in fact that is concrete, particularized, and actual or imminent
- The injury was caused by the defendant –and–
- The injury would likely be redressed by the requested judicial relief

Thole, 140 S. Ct. at *22. However, the Department of Labor still has the authority to maintain such actions. See ERISA 502(a)(8) (29 1132(a)(8).

Conflict of Interest

Closely related to the duty of loyalty is the prohibition against fiduciaries entering into transactions that constitute a conflict of interest under ERISA. ERISA § 406 (29 U.S.C. § 1106). Since the employer's balance sheet directly benefits from decreased plan expenses and liability volatility, using plan assets to reduce expenses and volatility has the appearance of a conflict of interest. Best practice prior to implementing an LDI strategy is to direct corporate plan sponsors to consider engaging a third-party independent investment advisor to act as a co-fiduciary. As a further safeguard, direct the plan sponsor to request a written evaluation of the independent investment advisor fiduciary's analysis of the LDI strategy. The evaluation should assess the benefit to the plan's participants and beneficiaries versus the benefit that the strategy bestows upon the plan sponsor.

Duty of Prudence

Traditionally, investing plan assets prudently has meant maximizing the return on those assets while minimizing risk. However, most of the literature on LDI strategies focuses on minimizing pension expense and liability volatility. This inherently means sacrificing some return upside in exchange for risk reduction. ERISA's prudence requirements, as interpreted by the DOL, do not preclude the use of any particular investment strategy. There is little discussion of the benefit to plan participants and beneficiaries of adopting and implementing such a strategy (but see the section below entitled "DOL Guidance and Court Rulings"). The general rule applicable to plan fiduciaries is that they diversify plan investments to minimize the risk of large losses unless, under the circumstances, it is clearly prudent not to do so. ERISA § 404(a)(1)(C) (29 U.S.C. § 1104(a)(1)(C)).

Duty to Monitor

As with any other investment strategy, once selected and implemented, plan fiduciaries have a duty to monitor the LDI strategy. As a rule of thumb, direct the plan fiduciary to update about every three to four years any LDI strategy that has adopted. An adjustment to the plan's investment policy statement may be required. Underfunded plans frequently implement an LDI strategy in stages by matching tranches of liabilities with similar investments. As a result, administering the strategy may be more complex for plans that have taken advantage of statutory funding relief, such as that available under the Moving Ahead for Progress in the Twenty-First Century Act and the Highway and Transportation Funding Act of 2014 (MAP-21). This is because MAP-21 permitted use of higher 25-year average interest rates that typically lowers plan liabilities. This should be recognized when matching liabilities with investments. For a specific discussion regarding the impact of MAP-21 on actuarial valuations in defined benefit plans, see Lexis Tax Advisor -- Federal Topical § 1C:12B.02, at Section [6][a].

DOL Guidance and Court Rulings

In Advisory Opinion 2006-08A, the DOL concluded that implementing an investment strategy designed to reduce the volatility of the plan's funding requirements would not by itself violate ERISA. Dep't of Labor Advisory Opinion 2006-08A (Oct. 3, 2006).

The Advisory Opinion responded to an investment manager's specific query whether plan fiduciaries could implement LDI strategies without violating ERISA. According to the investment manager, by better matching the plans assets with the plan's liabilities, the LDI strategies would reduce the likelihood that plan liabilities would rise at a time when plan assets were declining. Additionally, reducing funding level volatility, the investment manager argued, would reduce the risk of underfunding for the plan and its participants. The investment manager also noted to the DOL that the plan sponsor would incidentally benefit from the LDI strategies by having reduced volatility on its financial statements and reduced minimum contribution obligations. The reduced volatility would also diminish the need for the plan to rely upon the employer to meet its funding obligations, thus protecting the plan's participants in the event of the plan sponsor's insolvency.

In response, the DOL noted that plan fiduciaries have broad discretion to implement investment strategies. The agency noted that these strategies should be appropriate to the plan within the framework of ERISA's prudence, exclusive purpose, and diversification requirements. In addition, the DOL could find nothing in ERISA or its regulations that would impede a plan fiduciary's ability to take into account the risks associated with benefit liabilities and how those risks relate to portfolio management in designing an investment strategy. Concluding, the DOL said that plan fiduciaries do not violate ERISA by implementing an LDI strategy for the purpose of reducing volatility of the plan's funding requirements. The DOL did note that, as with any other investment strategy, an LDI strategy requires monitoring to track the efficacy of the strategy. For a general discussion regarding the ERISA duties of loyalty, diversification, and its exclusive purpose rule, see ERISA Fiduciary Duties.

ERISA Duty of Loyalty and Conflict of Interest

The Advisory Opinion did not explicitly address the loyalty or conflict of interest rules of ERISA. ERISA 404 (29 U.S.C. § 1104). Some court cases, such as Donovan v. Bierwith, 680 F.2d 263 (2nd Cir. 1982), have acknowledged that plan fiduciaries may take action that incidentally benefits the employer if that action is taken with an "eye single" to the interest of plan participants and beneficiaries. Similarly, the DOL, through its Advisory Opinion, has noted the Supreme Court's recognition and implicit approval of plan sponsors' receipt of incidental benefits (such as employee attraction and retention) by virtue of offering employee benefit plans. In the DOL's view, the mere receipt of such incidental benefits by a plan sponsor would not result in an ERISA violation.

Best Practices When Implementing an LDI Strategy

When implementing an LDI strategy, advise plan sponsors and fiduciaries to take additional precautions to guard against the appearance of impropriety. In particular, plan fiduciaries should focus on the strategy's benefits to plan participants and beneficiaries rather than to the plan sponsor. Prepare or review minutes of the investment or benefit committee meeting to highlight that the principal aim of LDI strategy implementation would be to strengthen the plan's solvency. Identify any reduction in the impact of the plan's investment volatility on the plan sponsor's financial statement, at most, as an incidental benefit to the employer.

Recuse Corporate Officers from Investment Committee

Since corporate finance officers (such as the chief financial officer, treasurer, or comptroller) have strong employer interests, courts or regulatory agencies may deem that

LDI strategies implemented by those officers are not in the best interest of plan participants and beneficiaries. This is particularly the case if the resulting strategy significantly reduces the plan's expected rate of return for its overall portfolio of investments. Corporate plan sponsors can of course consult their finance officers and ask them to individually approve any LDI proposal on the employer's behalf. However, those officers, if members of the plan's investment committee, should consider either being physically absent or recuse themselves from the committee's actual vote or approval of any LDI proposal and should not otherwise exercise their discretionary fiduciary authority over the LDI strategy.

Hire Outside Experts

Advise the plan fiduciary to consider engaging an independent investment adviser to act as a co-fiduciary for both the implementation and monitoring of an LDI strategy. Recommend this approach especially if the corporate financial officers do not participate in the implementation decision, per the discussion above.

Adopt or Amend an Investment Policy Statement (IPS)

While ERISA does not formally require an IPS, it is both a highly recommended best practice and an item that the DOL will ask for upon audit. If a new IPS is being adopted, or an existing IPS is being revised, include discussion of an LDI strategy instead of or in addition to discussion of a traditional balanced equity/asset allocations. The IPS should reflect the LDI strategy. Without this addition, the investment committee may face unnecessary exposure to a breach of fiduciary liability claim.

In addition to documenting the LDI strategy in the IPS, examine the plan document and trust agreement. You may need to amend those documents to add named fiduciaries to implement the LDI strategy and/or to accommodate the use of financial derivatives in the plan's overall investment strategy.

Other Strategies to Address Defined Benefit Plan Risk

In addition to LDI, plan sponsors have mitigated risks associated with their defined benefit plans through use of:

- Lump-sum window programs
- Annuity buy-ins –and–
- Annuity buy-outs

Another approach that has been requested, but is not currently available, is the transfer of plan assets and liabilities to an unrelated third party, in a transaction other than an M&A transaction. Each of these is discussed in the following sections.

Lump-Sum Window Programs

In a window program, a plan sponsor pays a lump-sum benefit to specified plan participants who are not in pay status. Window programs transfer market risk and longevity risk from the plan sponsor to the plan participant, as each individual participant is responsible for managing the lump-sum payment amount from the payment date until death.

Window programs produce savings in the plan sponsor's required premium payments to the PBGC. By reducing participant headcount, on which the PBGC flat rate premium is based, a window program reduces the sponsor's PBGC flat rate premium liability. See ERISA § 4006(a)(3)(A)(i) (29 U.S.C. § 1306(a)(3)(A)(i)). That rate is $83 per participant for plan years beginning in 2020 (rising to $86 for 2021). Thus, the plan amendment providing a lump sum to participants with a deferred vested benefit has a net present value benefit to the plan sponsor as it reduces future annual PBGC premiums. This savings lasts through the life expectancy of each participant who accepts a lump-sum offer. Underfunded single employer plans are also subject to the PBGC variable rate premium which, for 2020, is $45 per $1,000 of the plan's unfunded vested benefits, subject to a per-participant cap of $561 ($46, with a $582 cap, for 2021). As a result of distributing a lump-sum benefit and reducing its associated plan liability, the window program, by reducing headcount, can produce immediate PBGC premium savings of nearly $600 per participant for an underfunded plan.

Participants in Pay Status Again Eligible for Lump-Sum Cash-Outs

In 2015, the IRS provided that, going forward, participants in pay status who are receiving an annuitized benefit under an ongoing plan are not eligible to convert their remaining plan benefit to a lump-sum cash-out, contrary to the practice of many plans based on earlier IRS guidance interpreting the required minimum distribution (RMD) rules (e.g., I.R.S. Priv. Ltr. Rul. 201228045, 2012 PLR LEXIS 574 (Apr. 19, 2012)). I.R.S. Notice 2015-49, 2015-2 C.B. 79. However, the agency reversed its position again and no longer intends to amend the RMD rules to formally prohibit the practice. Subject to further guidance, the IRS will not challenge a plan amended to provide a cash-out window to participants in pay status that otherwise complies with the IRC. I.R.S. Notice 2019-18, 2019-13 I.R.B. 915.

Annuity Buy-Ins

In an annuity buy-in, a plan sponsor purchases group annuities from insurance companies on subsets of plan participants. The annuity remains a plan asset. The plan sponsor pays premiums to the insurer in exchange for a guaranteed stream of income that matches pension liabilities. The annuity is, in effect, a liability matching asset, thus ensuring that tranche of assets will equal that tranche of liabilities.

Annuity Buy-Outs

Similar to an annuity buy-in, a plan sponsor's annuity buy-out shifts the sponsor's obligations to an insurance company. The primary difference is that the insurance company pays annuities directly to participants in an annuity buy-out situation, as opposed to the plan sponsor. This strategy not only reduces the plan's liabilities, but also reduces the number of participants (and the PBGC premiums associated with those participants) and the plan assets that the plan sponsor needs to manage.

Plan Transfer Transactions

The IRS disallowed this early form of risk transfer. Rev. Rul. 2008-45, 2008-2 C.B. 403. Here, in a plan transfer transaction, the plan sponsor transfers the plan's assets and liabilities to a shell corporation in consideration for the shell corporation's assumption of the plan. A financial services firm would then acquire at least 80% of the stock of the shell corporation, so that the shell corporation becomes part of the same controlled group as the financial services company. In this manner, the financial services firm acquires a frozen defined benefit pension plan and the plan sponsor transfers responsibility for the operation and funding of the plan to the investment firm thus, removing a funding obligation from its balance sheet.

Through Rev. Rul. 2008-45, the IRS has ruled that this structure violates the exclusive benefit rule of I.R.C. § 401(a). While it is clearly permissible to transfer sponsorship of a business in connection with a corporate M&A transaction, the IRS distinguishes plan transfer transactions from M&A transactions. Under the ruling, the IRS will disallow a plan transfer transaction where:

- Substantially all of the business risks and opportunities under the proposed transaction are those associated with the transfer of plan sponsorship –and–
- The shell corporation is an employer under the I.R.C. controlled group rules immediately prior to the transfer but the subsidiary's ownership is transferred to a the financial services firm, a wholly unrelated entity

Notably, in conjunction with Rev. Rul. 2008-45, the Treasury Department issued a press release containing a framework of principles developed in conjunction with the DOL, the PBGC, and the Commerce Department that would allow pension buyouts of frozen plans. The Treasury Department would allow such transactions where they serve the best interests of plan participants, their beneficiaries, employers, and the PBGC.

To date, Congress and the Treasury Department have not taken legislative or regulatory action on the announced framework of principles. For an additional discussion by the U.S. General Accounting Office, see GAO-09-207 (Mar. 2009).

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Ms. Wagner was appointed to the IRS Tax Exempt & Government Entities Advisory Committee and ended her 3-year term as the Chair of its Employee Plans subcommittee, and received the IRS' Commissioner's Award. She has also been inducted as a Fellow of the American College of Employee Benefits Counsel. She is AV-rated by Martindale-Hubbell as having very high to preeminent legal abilities and ethical standards and has been listed in the Top 50 Women Lawyers in New England in New England Super Lawyers Magazine for 2016.

Ms. Wagner has written hundreds of articles and 23 books. She is widely quoted in business publications such as The Wall Street Journal, Financial Times, Pension & Investments, and many more, as well as being a frequent guest on FOX, CNN, Bloomberg, NBC and other televised media outlets.

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Barry L. Salkin concentrates his practice in ERISA and employee benefits law. He has significant expertise drafting, amending and negotiating various ERISA and employee benefit plans, including defined benefit pension plans, profit-sharing plans, 401(k) plans, as well as qualified and non-qualified deferred compensation programs. He also has wide-ranging experience crafting group medical and health plans involving Health Care Reform, HIPAA, and COBRA. In addition, he has represented clients in ERISA litigation and audits.

His clients include multi-national corporations, closely-held companies, high-net-worth individuals, financial institutions, governmental agencies, investment groups, and tax-exempt organizations such as hospitals and physicians' organizations.

Barry also advises clients on all aspects of retirement plan tax-qualification requirements and the application of labor and securities laws and regulations to sponsors of employee benefit plans and executive compensation programs. Moreover, he has extensive experience in establishing, merging and terminating benefit plans and compensation agreements, and counsels clients on fiduciary responsibilities and prohibited transactions.