October 1, 2010

J. Mark Iwry
Senior Advisor to the Secretary
Deputy Assistant Secretary-
Retirement and Health Policy
1500 Pennsylvania Avenue, NW
3120 Main Treasury Building
Washington, DC 20220

Andrew Zuckerman
Director of the Office of Rulings and Agreements
Internal Revenue Service
1111 Constitution Avenue, NW
483 Penn Building
Washington, DC 20224

Alan Tawshunsky
Deputy Division Counsel/Deputy Associate Chief Counsel (Employee Benefits)
Internal Revenue Service
1111 Constitution Avenue, NW
Room 4302
Washington, DC 20224

Dear Mark, Andy, and Alan:

The American Benefits Council (the "Council") and the National Coordinating Committee for Multiemployer Plans ("NCCMP") would like to raise an important issue related to annuitization. This issue directly relates to concerns about the fact that so few participants elect an annuity under a defined benefit plan when a lump sum distribution is available.

The Council is a public policy organization representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

NCCMP is an organization of national, regional, and local multiemployer pension and health and welfare plans, international and local unions, national and local employer associations, individual local employers, and multiemployer plan professionals. NCCMP has represented the interests of multiemployer plan participants for more than 30 years with respect to legislative, regulatory, and judicial issues.

Partial Annuitization

As you know, if the choice under a defined benefit plan is between an annuity distribution of a participant's entire benefit or a lump sum distribution of such benefit, the overwhelming majority of participants elect a lump sum distribution. Some employers that are concerned about this have explored the possibility of offering partial annuitization. Comments submitted in response to the request for information regarding lifetime income options issued by the Department of Labor and the Department of the Treasury indicated that it is much more likely that a participant will elect to annuitize if he or she could annuitize only a portion of his or her benefit.

In this regard, we were very encouraged by the testimony that you gave, Mark, at the hearing before the Senate Special Committee on Aging on Lifetime Income Options for Retirement on June 16, 2010:

- **Often the choice of lifetime income is presented or perceived as an all-or-nothing choice, which may have the effect of discouraging people from selecting any lifetime income. In fact, however, many individuals might best achieve their personal objectives by applying only a portion of their retirement savings to a lifetime income option, while continuing to invest the remainder and draw it down as needed.**

    - **We are considering whether regulations or other guidance present any unnecessary impediments to choosing partial guaranteed lifetime income.**

- **This all-or-nothing framing of the lump-sum versus income choice can arise in defined benefit as well as 401(k) and other plans. In fact, it may be particularly important to consider this issue in the defined benefit context, because those plans, in contrast to a majority of 401(k) plans, already offer lifetime income options (and indeed are required to make them the default option).**

<u>Obstacle to Partial Annuitization</u>

The problem addressed here is a potentially significant obstacle discouraging defined benefit plan sponsors from amending their plans to offer partial annuitization. That obstacle is a concern that a possible counterintuitive interpretation of the law could make partial annuitization artificially expensive, and could even lead to less annuitization.

Assume the following facts. A 55-year old unmarried participant is eligible for an early retirement benefit that is the actuarial equivalent of the normal retirement benefit commencing at age 65. The plan offers lump sum distributions based on the section 417(e) required assumptions. For purposes of determining actuarial equivalence with respect to the annuity distributions, the plan uses a 7.5% interest rate and the male Uninsured Pensioners 1994 Mortality Table (also known as the 1994 Group Annuity Mortality Basic Table).

The participant's normal retirement benefit at age 65 is a single life annuity of $30,000 per year. Under the plan, the actuarially equivalent annuity available at age 55 is $11,452 per year. The lump sum distribution available at age 55, using 2010 417(e) lump sum assumptions with a look-back month of November, 2009, is $200,284.

Assume, however, that the plan is amended to allow participants to elect any portion of their benefit (in 10% increments) in the form of a lump sum distribution and the remaining portion in the form of an annuity. The participant elects to split the benefit 50-50. Logically, this should be very straightforward. The participant's single life annuity should be $5,726 per year (i.e., half of $11,452) and the lump sum distribution should be $100,142 (i.e., half of $200,284). However, it is our understanding that at least some in the government have expressed the view that the section 417(e) rules would, in this example, apply not only to the lump sum portion of the distribution but also to the single life annuity portion. Thus, the single life annuity available to the participant under this option would be determined using the section 417(e) factors, yielding a single life annuity at age 55 of $6,836 and a lump sum distribution of $100,142.

Based on these numbers, participants would be unlikely to fully annuitize their benefits. By taking the partial annuitization option, participants would receive 60% of the fully annuitized benefit in addition to half of the otherwise available lump sum.

A different example more starkly illustrates the issue. Assume the participant chooses to receive 10% of her benefit as a lump sum and the remaining 90% as an annuity. In this case, applying the 417(e) factors to both the partial lump sum and the partial annuity results in a lump sum distribution of $20,028 and a single life annuity at age 55 of $12,304, i.e., 7.4% larger annuity benefit than she would receive by fully annuitizing her benefit.

Thus, by offering the partial annuitization option, the employer would be creating the following negative results:

- The employer would be effectively precluding use of the full annuitization option in many circumstances, since full annuitization would be -- or appear to be -- economically disadvantageous.
- The employer would be increasing plan costs materially with respect to participants who would otherwise elect full annuitization.
- The employer would face a difficult communication challenge in explaining the resulting benefit values, and the participants would understandably find the different values difficult to comprehend.

Anecdotal evidence indicates that most single employer and multiple employer plans do not offer a partial annuitization option today. If reports they have heard of the possible adverse position described above are confirmed or made official, one would not expect that to change.

<u>Partial Lump Sums</u>

By contrast, a fair number of multiemployer plans (and some single employer and multiple employer plans) have long offered partial annuitization, through a format that some call a "partial lump sum." For cultural and other reasons, the great majority of multiemployer defined benefit plans pay benefits only in annuity form. Given how attractive lump sums are to retiring employees, in some cases the trustees have compromised by offering the opportunity to take part of their benefit as a single sum, with the remainder saved for a life annuity. For example, a plan may allow a retiring employee to take 10% of his or her monthly benefit as a lump sum, and then pay the remainder in one of the annuity forms otherwise available (with the QJSA as the default). We are not aware of any plans that apply the counterintuitive interpretation described above. On the contrary, they allow a participant to elect wholly separate distribution forms with respect to the two different portions of his or her benefit, with the section 417(e) assumptions only applying to the non-annuity portion. So, a participant who is entitled to, say, $2,000 a month might choose to receive 10% of that as a lump sum equal to the present value of a $200/month life annuity, determined based on 417(e) factors. The residual annuity would be the actuarial equivalent of $1,800 a month for the retiree's lifetime using the plan's stated annuity conversion factors.

As the calculations laid out above show, if the reported adverse interpretation were applied to these situations, a participant might be able to get a higher pension by choosing a partial lump sum than by accepting the standard annuity. Not only would this come as a complete surprise to the parties sponsoring these plans, who had chosen to offer partial lump sums as an accommodation to participant requests, it could throw their funding and investment policies into disarray.

Legal Analysis

The regulations under section 417(e) do not directly address the partial annuitization/partial lump sum issue. Those regulations simply provide that the section 417(e) present value requirement:

> …does not apply to the amount of a distribution paid in the form of an annual benefit that –
> (i) Does not decrease during the life of the participant, or, in the case of a QPSA, the life of the participant's spouse; or
> (ii) Decreases during the life of the participant merely because of –
> (A) The death of the survivor annuitant (but only if the reduction is to a level not below 50% of the annual benefit payable before the death of the survivor annuitant); or
> (B) The cessation or reduction of Social Security supplements or qualified disability benefits (as defined in section 41l(a)(9)).

Apparently, under the possible adverse view expressed by some, in order to fit within this exception to the section 417(e) present value requirement, the entire benefit must satisfy the above quoted provision even if the benefit is offered in two completely separate forms. Under this interpretation, a distribution of any amount of a participant's benefit in the form of a lump sum renders the exception inapplicable. One can theoretically read the regulation that way. But in our view, there is no reason to do so either technically or from a policy perspective. Section 417(e) was intended to protect participants with respect to the value of lump sum distributions. There was no intent to apply the same actuarial requirements to annuity distributions just because part of a benefit is payable in a different form. We are unaware of any possible policy reason for Congress to have intended such a result. In other words, the adverse interpretation appears to be at odds with Congressional intent and policy considerations and not at all compelled by the language of the statute or regulations.

We ask that Treasury and the Service clarify in public guidance that the cited regulatory exception to the section 417(e) present value requirement can apply to any portion of a participant's benefit that is separately offered and elected. We would strongly prefer the guidance to be regulatory so that there can be greater certainty for plan sponsors that are considering whether to offer partial annuitization and those that now offer partial lump sums. This would provide employers with an option to offer partial annuitization and help preserve the financial integrity of plans with a partial lump sum option.

Just as is the case with defined contribution plans, the availability of a partial annuitization option under a defined benefit plan can be extremely helpful in facilitating the election of annuities. Without the clarification described above, plan sponsors will be far less willing to offer such an option.

We greatly appreciate your consideration of our views. If you have any questions with respect to this letter, please contact Lynn Dudley (ldudley@abcstaff.org, 202-289-6700) or Randy G. DeFrehn (rdefrehn@nccmp.org, 202-756-4644).

American Benefits Council National Coordinating Committee for Multiemployer Plans

cc: William Bortz
George Bostick
William Evans
Lauson Green
Helen Morrison
Linda Marshall
Martin Pippins
Laura Warshawsky
Harlan Weller
Carol Zimmerman