ERIC

The ERISA Industry Committee

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Submitted through the Federal eRulemaking Portal:
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Internal Revenue Service
CC:PA:LPD:PR (Reg-110980-10) Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Comments on Partial Annuity Regulations

Ladies and Gentlemen:

The ERISA Industry Committee ("ERIC") is pleased to submit these comments on the proposed regulations related to present value requirements for partial annuity distribution options ("Split Payment Options") under defined benefit plans. The proposed regulations were published in the *Federal Register* on February 3, 2012.

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care, and other economic security benefits directly to tens of millions of active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver effective and secure retirement benefits.

ERIC supports efforts to "reduc[e] regulatory barriers in order to increase interest in lifetime income, encourage innovation among stakeholders, and expand choices for individuals with a view to promoting greater retirement security."[1] As part of these efforts, ERIC welcomes the proposal to state affirmatively in regulations that if a Split Payment Option is offered, the minimum present value requirements of Code § 417(e) will apply only to the portion of the benefit that is paid in a lump sum. (For the sake of simplicity, we refer to a lump sum and any other form that, by itself, would be subject to Code § 417(e) collectively as a "lump sum.")

Our comments are intended to improve the usefulness of the regulations and to better accommodate plans that already allow Split Payment Options in accordance with a reasonable interpretation of Code § 417(e).

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[1] U.S. DEP'T OF THE TREASURY, TREASURY FACT SHEET: HELPING AMERICAN FAMILIES ACHIEVE RETIREMENT SECURITY BY EXPANDING LIFETIME INCOME CHOICES 2 (Feb. 2, 2012).

Summary of Comments

1. The final regulations should clarify that if a lump sum is payable only for a specified portion of a participant's accrued benefit (for example, benefits accrued before a specified date), Code § 417(e) assumptions are required only for that portion.

2. The final regulations should clarify that the present value of a benefit (or portion of a benefit) to which Code § 411(a)(13) applies may be calculated in any manner permitted by Code § 411(a)(13)(A), without regard to the applicable interest rate or applicable mortality table under Code § 417(e).

3. The proposed "single sum with separate election for remainder" rule should be expanded to apply for any form of payment that is subject to Code § 417(e).

4. For the following reasons, the final regulations should allow reliance on the regulations' interpretation of Code § 417(e) both prospectively and for the past:

    i. The statute does not require Code § 417(e) assumptions for the part of a benefit that is not paid in a lump sum. The proposed regulations implicitly recognize this fact.

    ii. Many plans already offer Split Payment Options and apply Code § 417(e) assumptions only for the lump-sum portion of the benefit. Where the statute has not changed, a regulation endorsing this approach should not put early adopters at risk.

    iii. Existing regulations do not clearly require Code § 417(e) assumptions for the portion of an accrued benefit that is paid in a non-417(e) form.

5. We respectfully request that the proposed bifurcation rule be applied for purposes of determining whether an optional form of benefit is redundant under Treas. Reg. § 1.411(d)-3(c).

Each of these comments is discussed below.

Discussion

1. If a lump sum is payable only for a specified portion of a participant's accrued benefit, Code § 417(e) assumptions should be required only for that portion.

The proposed rule for "separately determined benefits" (Prop. Treas. Reg. § 1.417(e)-1(d)(7)(iii)) reflects the intuitive conclusion that if a plan divides a participant's accrued benefit into two parts, and a lump sum is available for only one of those parts, Code § 417(e) should apply only to that part--and not to the other part. However, the proposed rule includes two conditions that can be interpreted to render the rule ineffective for many plans:

- First, the proposed rule states that the separate portions of the accrued benefit must be "determined without regard to any election of optional form of benefit." This

requirement is clearly satisfied for a plan with a bifurcated benefit formula (*e.g.*, a plan under which part of the accrued benefit is calculated using a final average pay formula and the rest is calculated using a cash balance formula). However, it is less clear whether this requirement is satisfied if a plan has a single formula and a lump sum is available only for benefits that accrued before a specified date.

The rationale for the "separately determined benefits" rule is the same in both cases: because the present value of each portion of the benefit can be calculated without regard to the other portion, it is not necessary to apply the Code § 417(e) assumptions for the portion of the benefit that is paid in an exempt annuity. The final regulations should be clarified to ensure that the separate portions requirement is satisfied whenever the plan specifies the portion of the accrued benefit for which a lump sum is available.

- Second, the proposed rule states that a participant must be allowed to "select different distribution options with respect to each…portion[] of the accrued benefit." It goes without saying that if a lump sum is available for only one portion of the benefit, the plan allows participants to select different options for each part of the benefit: a participant can elect a lump sum for one part and an annuity for the rest.

  It is common, however, for plans to require that if a participant declines the lump sum in favor of an annuity, the participant's entire accrued benefit must be paid in the same annuity form. This rule prevents administrative complexity that can arise if a participant elects more than one annuity form. The fact that a plan limits a participant's flexibility to choose a bifurcated annuity is not relevant to the calculation of a lump sum: regardless of what annuity forms are available, the portion of the benefit that may be paid in a lump sum is easily separated from the rest of the accrued benefit. The final regulations should be clarified to reflect this fact.

Specifically, the "separately determined benefits" rule (Prop. Treas. Reg. § 1.417(e)-1(d)(7)(iii)) should be revised to read as follows:

> (iii) Separately determined benefits. A plan satisfies the requirements of this paragraph (d)(7)(iii) to the extent that the plan designates two separate portions of the accrued benefit, and one or more distribution options available for one portion of the accrued benefit is not available for the other portion of the accrued benefit.

The final regulations should also include an example to show that the "separately determined benefits" rule applies for a plan under which a lump sum is available only for benefits accrued before a specified date. The example should make clear that the analysis is not affected by whether or not a participant is allowed to elect different annuity forms for each portion of the benefit.

2. The present value of a benefit (or portion of a benefit) to which Code § 411(a)(13) applies should be calculated in any manner permitted by Code § 411(a)(13)(A), without regard to the applicable interest rate or applicable mortality table under Code § 417(e).

Section 1.417(e)-1(d)(7)(v) of the proposed regulations states that if a plan allows a specified amount to be paid in a lump sum, the portion of the benefit that is not subject to Code § 417(e) is calculated as follows:

- First, calculate the present value of the participant's entire accrued benefit. Proposed section 1.417(e)-1(d)(7)(v)(C)(1) states that this present value must be "the present value of the accrued benefit payable at normal retirement age (or the immediate annuity if the participant is older than normal retirement age) determined using the applicable interest rates and the applicable mortality table."

- Second, the Plan must subtract the amount that is paid in a lump sum.

- Third, the amount of the distribution that is not paid in a lump sum (the annuity portion) must equal the amount that would be payable if the entire accrued benefit were paid in an annuity times a fraction. The numerator of the fraction is the present value of the accrued benefit minus the amount paid in a lump sum, and the denominator of the fraction is the present value of the accrued benefit.

The final regulations should clarify that, to the extent that Code § 411(a)(13) applies, the present value of the accrued benefit may be calculated in any manner permitted by Code § 411(a)(13). For example, suppose that a cash balance plan allows a lump-sum payment of a specified amount and the remainder of the participant's benefit must be paid in an annuity. Under Code § 411(a)(13), the present value of the participant's accrued benefit (or present value of the cash balance portion of the accrued benefit) may equal the balance of the participant's cash balance account. The statute states that calculating present value in this manner will not violate Code § 417(e). The final regulations should reflect this flexibility.

Specifically, proposed section 1.417(e)-1(d)(7)(v)(C)(1) should be revised to read as follows:

> (1) A single sum election were available with respect to the entire accrued benefit, where the single sum is the present value of the accrued benefit. Except to the extent that Code § 411(a)(13) applies, such present value shall be determined using the applicable interest rates and the applicable mortality table. To the extent that Code § 411(a)(13) applies, such present value may be calculated in any manner permitted by Code § 411(a)(13)(A), without regard to the applicable interest rate or the applicable mortality table.

This change is necessary to protect the flexibility expressly authorized by Code § 411(a)(13)(A). Requiring plans to calculate the present value for Split Payment Options differently than for distributions in a single payment form would be inconsistent with the statute.

3. The proposed "single sum with separate election for remainder" rule should be expanded to apply for any form of payment that is subject to Code § 417(e).

As discussed above, section 1.417(e)-1(d)(7)(v) of the proposed regulations sets forth rules for a plan under which a specified amount may be paid in a lump sum and a participant may make a separate election for the rest of his or her benefit. This rule should be expanded to apply not only for lump sums, but for any payment form that is subject to Code § 417(e). For example, the calculation methodology set forth in Section 1.417(e)-1(d)(7)(v) should apply if a plan allows a fixed amount to be paid in installments or a decreasing annuity and allows a separate election for the remainder of the benefit. We are not aware of any principle that necessitates treating a lump sum differently than any other payment form that is subject to Code § 417(e).

4. The final regulations should allow reliance both prospectively and for the past.

i. *The statute does not require Code § 417(e) assumptions for the annuity portion of a Split Payment Option.*

Code § 417(e) sets forth minimum present value requirements "for purposes of" determining whether consent is required for an immediate distribution. *See* Code § 417(e)(3). Courts have interpreted Code § 417(e)(3) to apply for any "immediate distribution" of the "present value" of a participant's benefit--*i.e.*, lump-sum distributions.[2]

Regulations issued under Code §§ 411(a)(11) and 417(e) have expanded the scope of the minimum present value requirement to apply for other forms of distribution. We understand that some expansion is appropriate to prevent circumvention of the statutory requirement. However, the risk of circumvention does not arise when Code § 417(e) assumptions are required for the portion of the benefit that is paid in a lump sum.

Indeed, the Preamble acknowledges that requiring Code § 417(e) assumptions for the annuity portion of a benefit is not "intuitive" (77 Fed. Reg. at 5454, 5456 (Feb. 3, 2012)), and the statute has not changed. The statutory language that supports prospectively requiring Code § 417(e) assumptions only for the lump-sum portion of the benefit supports the same approach for the past. Accordingly, the final regulation should expressly allow reliance for periods before the effective date.

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[2] *See, e.g.*, *Sunder v. U.S. Bancorp Pension Plan*, 586 F.3d 593, 601 (8th Cir. 2009) ("The structure and language of [Section 417(e)(3)] indicate that the statutorily prescribed rate must be applied to determine the present value of a benefit when a participant cashes out and receives a distribution."); *Thompson v. Ret. Plan for Employees of S.C. Johnson & Son, Inc.*, 651 F.3d 600, 602 (7th Cir. 2011) (describing Section 417(e) as a requirement for calculating lump-sum distributions); *West v. AK Steel Corp.*, 484 F.3d 395, 406-410 (6th Cir. 2007) (same).

ii. ***The new regulation's effective date should not put early adopters at risk.***

Many plans have offered Split Payment Options for a long time. These plans generally fall into three categories, each of which is mentioned in the proposed regulation:

i. Plans with an optional form of payment that provides for payment of a percentage or a fixed dollar amount in a lump sum, and the rest in an annuity;

ii. Plans under which a lump sum is available for only part of the benefit. For example, if a plan that offered a lump-sum option was merged into a plan that does not offer a lump-sum option, the lump-sum option may have been preserved for benefits that accrued before a certain date. Freezing optional forms for a frozen benefit was expressly permitted under the "fresh start" rules for nondiscrimination testing.[3] Similarly, many plans that converted to hybrid formulas allow a lump sum only for the hybrid portion of the benefit; and

iii. Contributory plans under which contribution refunds may be paid in a lump sum, but the rest of the benefit is paid in an annuity.

It is common for these plans to use Code § 417(e) assumptions to calculate the lump-sum portion of the benefit, but not for the rest of the benefit. These plans have received favorable determination letters; and we are not aware of a single case in which the assumptions for the annuity portion of the benefit were questioned. The decision to endorse this approach indicates that the sponsors of these plans were appropriately innovative.

As noted above, the existing practice is intuitive and consistent with the requirements of the statute. Because Code § 417(e) assumptions are applied for the lump-sum portion of the benefit, existing practice does not circumvent the statutory requirement. If Treasury and the Service truly wish to encourage innovation, a new regulation that endorses an existing practice should not introduce new questions for early adopters.

iii. ***Existing regulations do not clearly require Code § 417(e) assumptions for the portion of an accrued benefit that is paid in a non-417(e) form.***

The Preamble to the proposed regulation states that "[u]nder current regulations, both portions of [a Split Payment Option] are subject to the minimum present value requirements of section 417(e)(3)." 77 Fed. Reg. 5454, 5456 (Feb. 3, 2012). We believe that the Preamble refers to Treas. Reg. § 1.417(e)-1(d)(6), which states that Code § 417(e) assumptions are not required for "the amount of a distribution" paid in the form of a non-decreasing annuity. There is no suggestion in the regulation that "the amount of a distribution" refers to the entire benefit.

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[3] Treas. Reg. § 1.401(a)(4)-13(c)(3)(iii) contemplates that optional forms for frozen benefits are generally frozen, and allows changes to optional forms for frozen benefits only under limited circumstances.

To the contrary, the term "distribution" has been used in other contexts to refer to only part of a benefit. For example:

- Section 521 of the Unemployment Compensation Amendments of 1992 changed the rollover rules for "distributions after December 31, 1992." Pub. L. No. 102-318 (1992). For purposes of this rule, any payment made after December 31, 1992, is treated as a distribution made after December 31, 1992, even if the payment is part of a series that started before 1993. *See* Treas. Reg. § 1.402(c)-2, Q&A-1(c).

- Code § 402(c)(4) states that a series of substantially equal payments over 10 years or more is not an eligible rollover distribution. For purposes of this rule, a payment that is substantially larger or smaller than the rest of the payments in a series is treated as a separate "distribution." *See* Treas. Reg. § 1.402(c)-2, Q&A-6(a). The interpreting regulation states that if half of a benefit is paid in a lump sum and the other half is paid in an annuity, the lump-sum portion is treated as independent of the annuity. *Id.*

There is no reason to interpret the term "distribution" differently for purposes of Code § 417(e)(3).

At best, the language in the existing regulation is ambiguous. A regulation that resolves this ambiguity one way should not require the opposite conclusion for periods before the clarification--particularly where, as here, the same statute applies for periods before and after the effective date of the new regulation.

5. The bifurcation rule should also apply for purposes of determining whether an optional form of benefit is redundant under Treas. Reg. § 1.411(d)-3(c).

Code § 411(d)(6)(B) authorizes Treasury and the Service to issue regulations that allow plans to eliminate optional forms of benefit. Pursuant to this authority, Treas. Reg. § 1.411(d)-3(c) allows plans to eliminate redundant optional forms.

A common way for redundant optional forms to find their way into a plan is through plan mergers. For example, a plan that allowed participants to elect a joint and survivor annuity with any survivor percentage over 50% could have been merged into a plan under which the only permitted survivor percentages are 50% and 100%. Before the redundant optional form rules were published, it was common for plan sponsors to freeze the old forms. As a result, participants with merged benefits could receive bifurcated annuity payments: (i) the frozen, merged benefit in one optional annuity form, and (ii) the rest of the benefit in a different optional annuity form.

In practice, bifurcated annuities are quite unpopular, particularly when the frozen form is in the same family as an ongoing annuity form. Rather than elect a bifurcated annuity, most participants elect to receive their entire benefit in a single annuity that is in the same family. To simplify administration, it is therefore often desirable to eliminate the frozen annuity forms; and the redundant option rule would seem to facilitate that flexibility.

However, informal statements by representatives of the Service have raised questions about this flexibility. In answers to questions posed at the 2006 annual meetings of the Enrolled Actuaries

and the ABA Joint Committee on Employee Benefits, representatives of the Service stated that a bifurcated annuity must be treated as a separate family.[4]

This treatment is no more intuitive for redundant optional forms than for Split Payment Options. This treatment disadvantages plans that tried to simplify administration before the redundant option rule was introduced. Whereas redundant optional forms can easily be eliminated in connection with future plan mergers, legacy redundancies seem to be stuck--solely because the employer tried to streamline administration prospectively. The result is that the redundant option rule is useless to plans that most need to eliminate redundant options--*i.e.*, plans with an underbrush of unpopular frozen optional forms that built up over prior plan mergers.

To level the playing field and to realize the objective of the redundant option rule, future guidance should expressly allow the redundant option rule to be applied separately for frozen forms and ongoing forms.

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ERIC appreciates the opportunity to submit these comments. If we can be of further assistance, please let us know.

Sincerely,

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Kathryn Ricard
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[4] *See* Enrolled Actuaries 2006 Gray Book, Q&A-27 ("Plans with mixed frozen/ongoing optional forms may not apply the redundant options path separately with respect to the two portions of the accrued benefits."); 2006 JCEB Q&A-39 ("Each combination of forms is a separate family.")