Testimony on Partial Annuity Guidance
Seth Safra on behalf of ERIC, 6/1/2012

I. Introduction

A. Good morning. My name is Seth Safra. I am a partner of the law firm Covington & Burling, and I am here on behalf of The ERISA Industry Committee, commonly known as "ERIC."

B. ERIC appreciates the efforts that have been made to increase interest in lifetime income, and to encourage innovation, by reducing regulatory barriers. And we appreciate the opportunity to submit comments.

C. ERIC submitted three sets of comments on the lifetime income guidance:

1. Comments on partial annuities, which are the topic of this hearing;

2. Comments on the proposed regulations on longevity annuities--which we will discuss this afternoon; and

3. Comments on Revenue Ruling 2012-4, which addresses rollovers from defined contribution plans to defined benefit plans. We wish ***that*** guidance had also been issued in the form of proposed regulations so that we and others could comment on significant concerns. In any event, we would like to work with you to address those concerns.

D. As noted in our written comments, ERIC supports the sensible rule that if part of a benefit is paid in a lump sum and the rest is paid in an annuity, Section 417(e) applies only to the part that is paid in a lump sum.

E. Except to the extent that you have questions, I will not address everything that was included in our written comments. Rather, I would like to focus on three topics:

1. What rules should apply for the past;

2. The rule for separately determined benefits; and

3. Coordination with the present value rule for hybrid plans.

II. The first topic is what rules should apply for the past.

A. The Preamble says that--

> "Under current regulations, both portions of [a partial annuity] are subject to the minimum present value requirements of section 417(e)(3)."

B. This statement was surprising.

1. Start with the statute. I don't think there is any dispute that the statute does not require Section 417(e) assumptions for the portion of a benefit that is not paid in a lump sum.

2. Second, the regulations do not ***state*** that both parts of a Split Payment Option are subject to Section 417(e).

   The regulations [§ 1.417(e)-1(d)(6)] say that Section 417(e) does ***not*** apply for "***the amount of a distribution***" that is paid in a non-decreasing annuity.
   The "amount of a distribution" is not the same as the accrued benefit. For example, in the context of rollovers, Treasury and the Service have consistently interpreted the term "distribution" to refer to only part of a benefit.

   In other words, when part of a benefit is paid in a lump sum and the rest is paid in a non-decreasing annuity, the annuity portion is an ***amount of a distribution*** that is paid in a non-decreasing annuity. Even under the existing regulation, Section 417(e) should not apply to that amount.

   And this understanding has been consistently reflected in favorable determination letters.

C. At best, the existing regulations are ambiguous on how to apply Section 417(e) to partial annuities. In light of this ambiguity--and the fact that the statute has not changed--we have three requests:

1. First, the final regulations should withdraw the statement of what is required under the existing regulations.

2. Second, the final regulations should expressly endorse good faith compliance with a reasonable interpretation of the statute and existing regulations.

3. Third, the final regulations should include a retroactive safe harbor for plans that already have procedures that are consistent with the principles of the proposed or final regulations.

D. We respect the fact that reasonable minds can disagree on what is required by the existing regulations. But the ultimate task here is to interpret words of a statute that have not changed. We do not think it would be appropriate to say the words can be interpreted one way going forward, but not for the past. Any interpretation that is permitted for the future should also be permitted for the past.

Also, we believe that flexibility for the past is essential for encouraging innovation.

III. The second topic is the proposed rule for separately determined benefits.

A. The proposed rule for separately determined benefits says that if a benefit has two parts, and only one part is payable in a lump sum, Section 417(e) applies only to the part that is paid in a lump sum. I want to talk about how the rule would apply in two cases:

1. A frozen lump sum--that is, where a plan says that benefits accrued before a certain date can be paid in a lump sum; and

2. An A+B benefit--where you have two benefit formulas and the lump sum is available for only one of the formulas--as is common when a final average pay formula is converted to cash balance.

B. The proposed separately determined benefits rule has two requirements:

1. First, the separate benefits must be "determined without regard to any election of optional form of benefit."

a) This requirement is clearly satisfied for the A+B benefit. But it is not clearly satisfied for the frozen lump sum--at least where the plan has only one benefit formula.

b) We don't think the frozen lump sum should be treated differently than the A+B benefit. Even if the plan with a frozen benefit has only one formula, the fixed freeze date should be sufficient to establish separate benefit pieces.

2. The second requirement is that a participant must be allowed "to select different distribution options [for] each . . . portion[] of the accrued benefit."

a) Intuitively, this should always be satisfied if only one part is paid in a lump sum. But we are concerned that the requirement can be read to also require bifurcated annuities.

b) In our experience, very few plans offer bifurcated annuities--because they are not popular and they are administratively burdensome.

c) So, if bifurcated annuities are required, most plans will not be eligible for the separately determined benefits rule.

d) The final regulations should be clarified to avoid this result. The only thing that should be relevant for the separately determined

benefits rule is that an identifiable part of the benefit is paid in a lump sum.

IV. The third topic is coordination with the present value rule for hybrid plans.

A. This issue comes up in the proposed rule for "specified dollar amounts." The proposal says that if you specify a dollar amount to be paid in a lump sum, the annuity part of the benefit would have to be calculated in four basic steps:

1. First, determine the accrued benefit, expressed as a single life annuity starting at normal retirement age.

2. Second, calculate the present value of the entire accrued benefit, using the Section 417(e) assumptions.

3. Third, subtract out the amount of the lump sum.

4. Fourth, calculate an annuity fraction--which is the present value after subtracting the lump sum, divided by the total present value--and multiply that fraction by the accrued benefit, expressed as an annuity.

B. For hybrid plans, the first two steps can be read to require a whipsaw calculation. First, you have to convert the account balance to an annuity starting at normal retirement age. And then you have to discount that annuity to present value using Section 417(e) assumptions.

C. This would be inconsistent with Section 411(a)(13)--which says that the present value of a hybrid benefit can be equal to the account balance.

D. So, the final regulations should make clear that, for a hybrid plan, the present value of the accrued benefit can be equal to the account balance.

V. Conclusion

A. Thank you again for allowing us to share our views on the proposed regulations.

B. I welcome any questions.