AMERICAN ACADEMY of ACTUARIES

May 3, 2012

CC:PA:LPD:PR (REG–110980–10)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Modifications to Minimum Present Value Requirements for Partial Annuity Distribution Options under Defined Benefit Pension Plans

To Whom It May Concern:

The American Academy of Actuaries[1] Pension Committee respectfully requests your consideration of its comments regarding the proposed regulations under Internal Revenue Code (IRC) Section 417(e) with respect to partial annuity distribution options under defined benefit pension plans (REG–110980–10). The committee supports the effort to clarify and simplify the application of Section 417(e) to plans that pay benefits partly in the form of benefits subject to Section 417(e) and partly in another non-Section 417(e) form, and appreciates the opportunity to comment. The committee agrees that a roadmap to compliance with Section 417(e) will make offering partial lump sums more attractive to plan sponsors and that increased availability of such options will make participants more likely to elect a form of benefit providing some amount of lifetime income.

However, the proposed regulations appear to be premised on the interpretation of the current Section 417(e) requirements as having been clear from the regulations, well understood, and followed in practice and by design by most plans. Our anecdotal experience is that this has not been the case. This disconnect creates transition issues that should be addressed so that plan sponsors who have adopted disparate good faith interpretations of the current Section 417(e) regulations are not penalized.

Our comments focus on the following areas:

- Background and legislative intent;
- Specific comments on the proposed structure of the Section 417(e) exemptions, including clarifications needed;
- Transition issues.

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States

Terminology Reflected in our Comments

IRC Section 417(e) and Regulation Section 1.417(e)-1(d)(1) specify the interest rates and mortality table that must be used to determine both (a) whether a distribution can be made in a single sum without participant consent under Section 411(a)(11) (i.e., to determine whether the present value of the benefit does not exceed $5,000) and (b) the minimum benefit amount for payment forms subject to Section 417(e). For purposes of our comments, we refer to the applicable interest rates and applicable mortality table together as "Section 417(e) assumptions," and to payment forms subject to Section 417(e) as "Section 417(e) options."

In addition, we refer to the three types of scenarios for which the proposed regulations provide an exemption as Types I-III, as follows:

- **Type I-Distinct Benefits (i.e., "A+B" benefits)—**A plan provides for two (or more) separate portions of accrued benefit that are determined without regard to any election of optional form, and a participant can elect a different optional form of benefit for each piece.

- **Type II-Proportionate Benefits (i.e., X percent Section 417(e) options)—**A plan provides options that can be elected for the participants' entire accrued benefit, but which also can be elected for percentages of the accrued benefit. Each benefit (the Section 417(e) option and the non-Section 417(e) option) must be the appropriate percentage of what the benefit would be if the entire benefit were paid in that optional form. For example, if a participant elects 40 percent of his or her benefit paid as a lump sum, and 60 percent paid as a single life annuity, the lump sum paid must equal 40 percent of the lump sum that would have been paid if the entire benefit had been paid as a lump sum and the single life annuity must be 60 percent of the benefit that would have been paid if the entire benefit had been paid as a single life annuity.

- **Type III-Specified Lump Sum, plus Residual Annuity—**A plan provides for a specified amount to be available in a single sum, with the remainder distributed under another optional form of benefit. The remaining benefit not payable as a lump sum must be no less than would have been payable under the Type II rules had a full lump sum of the Section 417(e) present value of the normal retirement (or, if later, current age) benefit been offered. For example, if the lump sum benefit available is limited to $50,000, and the Section 417(e) present value of the normal retirement benefit is $200,000, and the participant chooses a qualified joint and survivor annuity (QJSA) for the remainder of the benefit, the QJSA must be no less than 75 percent of the QJSA that would have been payable if no lump sum was elected.

Background and Legislative Intent

Regulation Section 1.411(a)-4(a) effectively requires that optional forms be calculated using reasonable actuarial assumptions. The Internal Revenue Service (IRS), however, has never prescribed specific rules for "reasonable assumptions." As a result, a wide range of practices exist, including flat factors, factors based on reasonable fixed long-term interest rates, and factors based on variable interest rates (whether the rates are the applicable interest rates under Section 417(e) or other variable rates). Flexibility in setting conversion factors for pension plans is appropriate.

In enacting Section 417(e) as part of the Retirement Equity Act of 1984 (REA), Congress addressed a concern related to lump sum and similar payments, in which the lump sum paid in some circumstances could be viewed as an "unfair" settlement of the benefits owed. This might occur, for example, if the discount assumptions used to convert future benefit payments to a lump sum present value were higher than what the participant could reasonably expect to earn (e.g., by purchasing an annuity to replace the pension benefit, or by purchasing long term bonds) based on the interest rate environment in effect when the participant receives the lump sum. As a result of this concern, Section 417(e) prescribes minimum requirements a plan must satisfy to "immediately distribute the present value of such annuity."

In addition, we believe the legislative history makes clear that Congress only was attempting to regulate situations in which the plan was "immediately distributing the present value." For example, the Senate Finance Committee report that accompanied REA provided the following:

> "In addition, under the bill, if the present value of the benefit under a qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, the participant and spouse (or the surviving spouse if the participant has died) must consent in writing ***before the plan can immediately distribute the present value***. For purposes of computing the present value of a benefit as of the date of distribution, the plan is required to use an interest rate no greater than the rate used by the PBGC in valuing a lump sum distribution on plan termination." *(emphasis added)*

Congress therefore did not intend to prescribe assumptions to be used to convert from one life annuity form to another, but merely to require the payment of a minimum amount (calculated using Section 417(e) assumptions) when the plan was going to "immediately distribute the present value." IRS applies this rule to other payment forms that are similar to lump sums in that they convert benefits payable for life to benefits payable for a short period of time (e.g., installment payouts and Social Security level income options).

Anomalous results if Section 417(e) is applied to the entire benefit when a portion is paid as a lump sum

When benefits are paid partly as a Section 417(e) option and partly as a non-Section 417(e) option, it is important that the intent of the Section 417(e) rules not be subverted by the handling of the non-Section 417(e) form of benefit (e.g., if an improved value required by Section 417(e) is effectively eliminated through a wrap-around calculation of the residual annuity). But in all other cases, the requirement to apply Section 417(e) assumptions (as a minimum) to Section 417(e) forms of benefit should not in any way affect the remainder of the benefit.

A requirement to apply Section 417(e) conversions (as a minimum) to the *entire* benefit when *any* portion is paid in a Section 417(e) optional form is counterintuitive and can produce anomalous results. Consider the following example illustrating the potential effect of a small refund of employee contributions on the determination of a 50 percent joint and survivor (J&S) annuity option.

Participant age at annuity starting date (ASD) in 2013	65
Beneficiary age at ASD in 2013	62
Normal retirement age	65
Monthly accrued benefit payable at ASD	$1,500

Employee contributions with interest at ASD	$2,000	
Section 417(e) present value factor at ASD	11.9985	
Life annuity to 50 percent J&S conversion factor at ASD		
• Plan basis (5 percent, RR 2001-62 mortality)	0.9020	
• Section 417(e) basis	0.9131	
Section 417(e) present value of accrued benefit at ASD	$215,973	
Monthly 50 percent J&S annuity		
• Without withdrawal of employee contributions	$1,353	*($1,500 x 0.9020)*
• Assuming withdrawal of employee contributions	$1,357	*($213,973 ÷ 11.9985 ÷ 12 x 0.9131)*

In this example, taking a small lump sum could leave Participant A, who took the lump sum, with a larger residual J&S annuity than an identically situated Participant B, who did not take the lump sum. Whether such a situation would occur would depend on the relationship between the Section 417(e) assumptions and the reasonable plan factors not prescribed under Section 417(e).

In addition, because Section 417(e) optional forms also must be at least actuarially equivalent to the accrued benefit payable at the normal retirement date, taking a small lump sum could force a plan to use more generous early commencement factors for the residual annuity benefit. For example, a participant retiring early with an accrued benefit worth $300,000 and accumulated employee contributions of $1,000 could have the single life annuity provided increased by electing to take a refund of the employee contributions. This could occur if the plan's otherwise reasonable early retirement factors are less generous than Section 417(e) (e.g., if current Section 417(e) interest rates are unusually low).

Note that employee contributions are used in the examples above to illustrate the consequences of this interpretation because they tend to produce the most counterintuitive results. The issues, however, are not limited to plans that have employee contributions and can arise in any plan offering partial lump sums.

As a result of the potential for differences between the plan's reasonable assumptions and current Section 417(e) assumptions (particularly if the plan's assumptions are based on a fixed interest rate), and the lack of any demonstrated intention by Congress to prescribe assumptions for benefits that were not being immediately distributed in a single sum, we support the guidance in proposed regulations providing that Section 417(e) assumptions do not override a plan's specified basis for computing actuarially equivalent optional forms of annuity benefits.

Proposed Structure of Section 417(e) Exemption

The exemptions proposed in the regulations are appropriate and will cover many common situations. But we would request certain clarifications and suggest additional scenarios in which we believe relief would be appropriate. ***Separate Elections***

For ease of administration, many plans that offer partial lump sums require that if the lump sum is not chosen, the participant select one annuity form for the entire benefit. For example, assume that an "A+B" benefit formula makes B available as a lump sum (e.g., a cash balance formula), but A is not available as a lump sum (e.g., traditional formula for service prior to cash balance formula). If the participant does not choose a lump sum for the B portion of the benefit, the plan requires the participant to choose the same annuity option for the A and B portions of the benefit. A plan that allows full lump sums and a range of full annuity options, as well as allowing 50 percent (for example) of the benefit to be taken as a lump sum, similarly may not permit 50 percent of the benefit to be taken in one annuity option and 50 percent in a different annuity option. It is unclear from the wording of the proposed regulation that these two plans would meet the requirements to be designated either Type I or Type II respectively, because even though separate elections are permitted when the participant does elect a partial lump sum, a participant may not make separate elections for each portion of the accrued benefit if one of the portions is not elected as a lump sum.

Based on the legislative intent of Section 417(e) (discussed above), the Pension Committee does not believe there is a reason to require separate elections among non-Section 417(e) options (instead of only between Section 417(e) and non-Section 417(e) options). We recommend the descriptions of Types I and II be modified to clarify that the designs described above can be treated as Types I or II. We believe that not allowing an exemption in these cases will result in fewer plan sponsors offering partial lump sums (i.e., more plan sponsors offering only full lump sums), which appears contrary to the overall goal of this guidance.

As discussed below, even if the “separate election” requirement for Type I is retained, we believe these designs often will fit within Type III. The regulations would be clearer, however, if these designs instead fit within the Type I category they more closely resemble. In addition, a design that would be Type II, except that elections among non-Section 417(e) forms of benefit are not independent, could not fit within Type III, since Type III requires that the full benefit not be available as a lump sum.

Hybrid Plans

A plan’s available Section 417(e) option may be a cash balance account (for example) payable as a lump sum that is not calculated using Section 417(e) assumptions but rather is deemed to satisfy Section 417(e). We request confirmation that the exemptions are available whenever a form of benefit is subject to Section 417(e) (including when it is deemed to satisfy Section 417(e)).

Scope of Type III

While Type III appears designed to accommodate contributory plans that offer refunds of employee contributions, Example 3 in the proposed regulations illustrates another design that would satisfy the requirements of Type III (i.e., a lump sum limited to $10,000). In addition to the examples in the regulations, we believe that Type III also could include all of the following:

- An “A + B” plan, in which the full benefit is not available as a lump sum, but that does not satisfy Type I because elections among non-Section 417(e) options are not independent. (Note that this design would not need to fit within Type III if the separate election requirement for Type I was clarified as discussed above.)
- A design that would be Type II except that a full lump sum is not available. For example, if a plan offers 50 percent of the accrued benefit payable as a lump sum, the “specified amount

to be distributed in a single sum" referred to in the Type III description in the regulations then would be the lump sum present value of 50 percent of the accrued benefit.

- A lump sum equal to the present value of the benefit accrued as of a particular date (e.g., when a previously available lump sum option was eliminated).
- Certain wrap-around benefits (discussed in greater detail below).

As we believe that all of these designs promote annuities and should be permitted, we ask for confirmation in the final regulations that all of these designs are permitted within Type III (or otherwise).

Type III Limited to Lump Sums

Type III as written only applies to optional forms offering partial lump sums. As we do not see a policy reason to restrict Type III to lump sums, we ask that IRS consider making Type III available for any Section 417(e) option. For example, in addition to allowing a lump sum up to $100,000, a plan could permit up to $100,000 of the present value of the benefit to be received in five annual installments. A plan similarly could permit a participant to receive a Social Security level income option (i.e., by converting a portion of the single life annuity otherwise payable by the plan to a temporary additional benefit to age 62). While we agree that the portion of the single life annuity that has been converted to the temporary annuity needs to be determined using Section 417(e) assumptions, we believe that the remaining single life annuity, if available in other optional forms (e.g., as a QJSA), should not have to be converted to those optional forms using Section 417(e) assumptions.

Wrap-Around Benefits (with Section 411(d)(6) Protection of Optional Forms)

Assume that an acquired plan is amended to provide the acquirer's benefit formula for all service, with a minimum benefit (the prior plan benefit protected under Section 411(d)(6)) equal to the accrued benefit at acquisition. Assume also that the ongoing formula does not provide a lump sum, but the prior plan benefit is available as a lump sum. If the residual annuity is equal to the gross accrued benefit payable at age 65, less the accrued prior plan benefit, with the net amount reduced using the ongoing plan's optional form and early commencement factors, the benefit would meet all the conditions for Type I and would be exempt.

But if the residual annuity is calculated in a wrap-around fashion (that is, by applying the ongoing plan's optional form and early commencement factors to the gross all-service benefit and then subtracting from this an immediate annuity equivalent of the prior plan lump sum), the benefit does not appear to meet the Type I definition. This is because B (the residual) is not independent of the optional form elected for A (the prior plan benefit)—it depends on the lump sum conversion factors, the factors used to determine the annuity equivalent of the lump sum for offset purposes, and on differences in early commencement factors between the old and new formulas. The wrap-around approach does not fit Type II either (since a full lump sum is not available).

We agree that a plan should not be permitted to reduce the residual benefit in a manner that eliminates the increase in value from using Section 417(e) factors for the lump sum. Offset approaches are used, however, for other legitimate reasons. For example, the A benefit also may have subsidized early retirement factors and/or optional form factors that are not available with respect to the new plan benefit. Such subsidies are permitted to be worn away in the calculation of the residual benefit. Failing to provide an exemption from the requirement to use Section 417(e) assumptions for the non-Section 417(e) residual annuity adds an extra requirement on the residual calculation that is not otherwise required by Section 411(d)(6) and would not be required if the A piece was not available as a lump sum.

To avoid this issue, we request confirmation (perhaps through an example in the regulations) that wrap-around designs can satisfy Type III as long as (i) the lump sum paid with respect to the A piece is what the plan would have paid pre-amendment and (ii) the reduction to the gross benefit resulting from the lump sum payment is no more than the immediate annuity under the A formula. This approach ensures that the requirement to use Section 417(e) assumptions for the A portion of the benefit is not worn away but permits early retirement subsidies on the A piece to be worn away. At the same time it provides for early retirement subsidies in the ongoing formula to be preserved even if a lump sum is taken on the A piece.

Separate Annuity Starting Dates

The proposed regulations do not address situations in which the Section 417(e) option and the non-Section 417(e) option begin at different times (e.g., a refund of employee contributions at termination of employment with the residual annuity not available until age 55, or a cash balance benefit that is available at termination with a prior plan final average pay formula benefit that is not available until retirement eligibility). Because of the option election and annuity starting date rules, it is not possible for a plan to have a single option that is “a lump sum now and a joint and 50 percent survivor annuity payable 10 years from now.” (That would not be a valid election since the annuity portion of it would have been elected more than 180 days before its starting date.) As a result, we believe that these optional forms would be treated as separate in any event, and we request that the regulations make clear that any requirement to apply Section 417(e) to the entire benefit when part of the benefit is taken as a Section 417(e) option applies only to portions of the benefit that begin on the same annuity starting date.

Transition

The proposed regulations would formalize the IRS interpretation of the current Section 417(e) regulations (i.e., as requiring that, when part of a benefit is paid in a Section 417(e) form, all of the benefits payable be viewed as a single option subject to Section 417(e)) and would apply that interpretation retroactively.

We respectfully disagree with this approach. We believe that, before these proposed regulations were issued and as discussed above, it was reasonable to have interpreted the legislative history and IRC Section 417(e) to require the use of Section 417(e) assumptions (as a minimum) only for the portion of the benefit the present value of which was being distributed immediately.

We do not believe it was clear from the prior regulations that the IRS interpretation was the only reasonable approach.. Under Section 1.417(e)-1(d)(6), a “Section 417(e) option” is any payment form other than a distribution in the form of an annual benefit that either:

- Does not decrease during the life of the participant (or the life of the spouse in the case of a Qualified Preretirement Survivor Annuity):

- Decreases during the life of the participant (but not by more than 50 percent) merely because of the death of the survivor annuitant (i.e., a “true QJSA”);
- Decreases during the life of the participant merely due to the cessation of or reduction in a Social Security supplement (not a Social Security Level Income Option) or qualified disability benefits.

We believe the most straightforward interpretation of the language above is that the $100 is a Section 417(e) option and the $50,000 annuity is not, rather than the $100 lump sum plus a $50,000 single life annuity is a single option that decreases during the life of the participant (from $50,100 in Year 1 to $50,000 in Year 2 and thereafter). The preamble to the Section 417(e) regulations (dated August 22, 1988) supports this interpretation by saying, “Second, the actual single sum that the participant (or beneficiary) receives under the plan must be calculated using an interest rate not greater than the immediate PBGC rate (the “amount rule”)” (the preamble then goes on to discuss the change, in the final regulations, from the immediate PBGC rate to the “applicable interest rate”). In addition, every example in the regulations deals with a single-sum distribution.

As a result, many pension plan practitioners and plan sponsors believed that a plan paying part of the accrued benefit in a Section 417(e) form and part in a non-Section 417(e) form could treat the two as entirely separate optional forms of benefit. The Section 417(e) benefit was not less than the actuarial equivalent of that portion of the accrued benefit calculated using Section 417(e) assumptions, but the remainder of the benefit had no such requirement. This interpretation, if applied, was typically reflected in plan documents.

Evidence that the IRS’ current interpretation was not clear from the wording of Section 1.417(e)-1(d)(6) abounds. For example:

- The relative value regulations (Section 1.417(a)(3)-1(c)(5)(iii), Separate Presentations Permitted for Elections That Apply to Parts of a Benefit) permit options to be treated separately for relative value disclosures if there are independent elections for two or more portions of the benefit. Such an approach would make no sense if the election of a lump sum on one piece of the benefit would affect the amount of the other portion of the benefit (i.e., increasing it by applying Section 417(e) assumptions).

- Regulation Section 1.436-1(d)(3)(ii)(B) indicates that the rules of Section 417(e) apply separately to the restricted and unrestricted portions of the benefit when bifurcation is the result of partial restrictions on accelerated benefit distributions.

- Many determination letters have been issued to plans whose plan documents do not contain language that expressly complies with this interpretation.

- The existing regulations fail to indicate (by way of example or otherwise) the current IRS interpretation. There is no discussion of this interpretation in the preambles to any of the changes to the Section 417(e) regulations, nor in the Code itself or the legislative history. Given the profound potential consequences of this interpretation as illustrated above, it would appear that if such an interpretation were intended it would have been illustrated.

- The examples cited above (in which the receipt of a small lump sum can increase the remaining benefit, or separating the annuity starting dates for the two pieces can produce a drastically different result) illustrate the counter intuitive outcomes that could result from the IRS interpretation. It would not seem logical for plan sponsors to adopt an interpretation that produces such outcomes in the absence of clear guidance.

Section 411(d)(6) Protection

Given the factors discussed above, we believe that reasonable interpretations should be accommodated for both past and future periods. . Plans that did not apply the IRS interpretation of the current regulations should be required to comply in form with the structure of the final regulations for exemption, but we request the regulations state that no inference is to be drawn with respect to the compliance of the pre-existing terms of the plan. For plans with favorable determination letters, we request the regulations provide that the plan's current terms govern whether Section 411(d)(6) protection and/or a Section 204(h) notice is needed when making any changes to comply with final regulations (in other words, plans should not have to protect an approach they were not using). In addition, plans also should be exempted from any requirement to adjust benefits retroactively, which would be a massive, complex, and expensive undertaking requiring individual review of every potentially affected calculation.

Such an approach, however, still would leave concerns. For example, plan sponsors that previously adopted the IRS interpretation will be subject to onerous transition requirements to take advantage of the proposed regulations. If such plans are frozen then these requirements effectively may prevent them from making a change. In addition, plans that did not follow the IRS interpretation and that do not fit into Types I-III would need to protect an approach that does not comply with the final regulations. We also note that applying Section 411(d)(6) as described in the proposed regulation (i.e., a wear-away approach) would appear to conflict with Section 1.411(b)(5)-1(c)(2), which prohibits wear-away of Section 411(d)(6) protected benefits for plans that provide both hybrid and non-hybrid accruals and reduce the future accruals in the non-hybrid formula. We respectfully request that the IRS grant broad Section 411(d)(6) relief to alleviate these concerns.

Interaction with IRC 436

To the extent a plan currently follows the IRS interpretation and does not meet any of the three exemptions listed in the proposed regulations (or the plan sponsor chooses not to amend the plan to meet the exemptions), it is unclear what to do when Section 436 partial benefit restrictions require that Section 417(e) be applied separately to each portion of a bifurcated benefit. We suggest that if a plan specifically provides that Section 417(e) is applied to the entire benefit (as a minimum) if any portion of the benefit is paid in a Section 417(e) option (but not otherwise), the plan provision be interpreted to mean that Section 417(e) assumptions are applied only to the extent required by law and that the provisions of Section 1.436-1(d)(3)(ii)(B) would apply whenever the bifurcation was required by Section 436.

Effective Date

The regulations are proposed to be effective for annuity starting dates in plan years that begin on or after the date the final regulations are published in the Federal Register. We suggest that plan sponsors be permitted to rely upon the proposed regulations immediately.

The Pension Committee appreciates the opportunity to provide input to the IRS on these important regulations. We would be happy to discuss any of these items with you at your convenience. Please contact Jessica M. Thomas, the Academy's pension policy analyst (202-785-7868, thomas@actuary.org) if you have any questions or would like to discuss these items further.

Sincerely,

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Chairperson, Pension Committee
American Academy of Actuaries