

MEMO# 11772

March 31, 2000

PROPOSED SECTION 411(D)(6) RELIEF REGARDING OPTIONAL FORMS OF BENEFITS

1 Institute Memorandum to Pension Committee No. 31-98 and Pension Operations Advisory Committee No. 19- 98, dated May 22, 1998. 2 Institute Memorandum to Pension Committee No. 55-98 and to Ad Hoc Committee On Optional Forms of Benefit, dated August 28, 1998. March 30, 2000 TO: PENSION COMMITTEE No. \$\$\$-00 PENSION OPERATIONS ADVISORY COMMITTEE No. \$\$\$-00 RE: IRS PROPOSED 411(D)(6) RELIEF REGARDING OPTIONAL FORMS OF BENEFITS

The Internal Revenue Service has released proposed regulations that would establish special rules under section 411(d)(6) of the Internal Revenue Code to (1) permit the amendment of a defined contribution plan to eliminate some alternative forms of benefit distribution offered under the plan , (2) permit certain transfers between defined contribution plans that are not currently permitted under the regulations, and (3) permit the modification of certain rights to in-kind distributions. Background In 1998, the IRS issued Notice 98-29 seeking public comment on ways in which the Service might provide regulatory relief from the section 411(d)(6) "anti-cutback rule"¹ to enable the elimination of optional forms of benefit offered in a defined contribution plan and facilitate certain plan transfers of assets. The Institute submitted a comment letter at that time indicating its strong support for the development of such relief.² Specifically, with respect to optional forms of benefit, the Institute recommended that the Service permit employers to reduce optional forms of benefit offered in a defined contribution plan to a choice between a lump sum benefit and one extended form of payment option. We noted that if the Service adopted such a rule, participants would not lose a "valuable right," as defined in current regulations, because a lump sum distribution option provides participants the ability to replicate any other form of benefit. We noted the particular concerns that arise from the accumulation of multiple payment options in the prototype plan environment, and in the case where plans are consolidated and certain benefit accruals frozen as a result of corporate mergers and acquisitions. Both situations were cited in the preamble to the proposed regulations as reasons why the proposed relief is appropriate. In general, the proposed regulations adopt the approach the Institute suggested with respect to the elimination of optional forms of benefit. We further recommended that the Service expand the availability of elective transfers, which would promote benefit portability and enhance participants' ability to consolidate manage their retirement savings. We particularly noted the difficulties that arise as a result of the "same desk rule,"³ 3 A plan providing for periodic payments over life expectancy could provide for the life expectancy to be fixed when payments begin or could provide for the life expectancy to be redetermined annually, as described in section 401(a)(9)(D). 4 In the Institute comment letter, we recommended that

there be no “hierarchy” of extended forms of payment that would be require a life annuity to be preserved, rather than an installments over life option. 5 In this regard, the Institute in its comment letter noted that because participants with a single-sum distribution option can take that distribution and replicate any other form of distribution, section 411(d)(6) itself would not require the retention of any distribution options other than the single-sum form. 2 which applies to 401(k) plans. The proposed regulations significantly liberalize the elective transfer rules, most notably, eliminating the requirement that a benefit be distributable under the terms of the plan from which they are being transferred in order to take advantage of them. The Proposed Regulations Elimination of Optional Forms of Benefit. The proposed regulations would permit a defined contribution plan to be amended to eliminate nearly all existing forms of payment if certain specified forms of payment are available. Specifically, a plan can be amended to eliminate optional forms of benefit if, after the amendment, the distribution choices available include both a single-sum distribution and payment of the accrued benefit in an “extended distribution form.” If the plan prior to amendment provided either (1) a life annuity or (2) periodic payments over the participant’s life expectancy (or, at the election of the participant, over the joint life expectancy of the participant and participant’s spouse)³ the requirement that an extended form of benefit be retained can be satisfied only by providing either of these benefit forms. Example 1 in the proposed regulations (at page 16552 of the Federal Register notice) appears to clarify that substantially equal installments made over life expectancy can substitute for an annuity form of that benefit that was previously offered in the plan.⁴ However, in cases where there was neither a life annuity nor periodic payment over life option in the plan prior to its amendment, the proposed regulations would permit the “extended distribution form” requirement to be satisfied by offering a distribution in the form of substantially equal periodic payments made not less frequently than annually over a period at least as long as the longest period over which the participant is entitled to receive distribution in the plan prior to its amendment. In the preamble to the proposed regulations, the IRS indicates that many commentators made a strong case that plans should be able to eliminate all but the single-sum distribution option,⁵ but it determined that retention of an extended form of benefit would provide some advantages to participants, especially less sophisticated participants. The Service, however, continues to seek comment on whether the final regulation should include a requirement that an extended form of benefit be retained as an option in a plan eliminating multiple distribution options. Additionally, the preamble sets forth a number of questions upon which comments are sought. Specifically, the Service asks whether the regulations should: (1) require preservation of an extended distribution form at all or limit the requirement to only participants that have reached a specified age; (2) create exceptions for small businesses; (3) expand the benefit options for satisfying the “extended distribution form” requirement, including transfers to a defined benefit plan or installments over 20 years; (4) create exceptions for plans that merge into plans without extended payment options in connection with a corporate merger or acquisition; (5) add additional protections for participants if extended distribution forms are permitted to be eliminated, such as a delay in when the amendment doing so is implemented or making the amendment inapplicable to participants who have reached a certain age. Voluntary Transfers Between Plans. The proposed regulations would make a number of changes to existing regulations relating to elective transfers between qualified plans. Existing regulations do not permit an elective transfer from one qualified plan to another unless the participant’s benefit under the transferring plan is immediately distributable. This has precluded use of the elective transfer provision in connection with merger and acquisition transactions involving many 401(k) plans (as a result of the “same desk rule”). The proposed regulation permits many types of elective transfers regardless of whether the participant’s benefit is immediately

transferable. Specifically, the elective transfer provision would be available for transfers made in connection with corporate transactions, such as mergers and acquisitions, or in connection with the transfer of a participant to a different job that is not covered by the transferor plan, even if the event is not one that allows a distribution and even if the participant's benefit is not fully vested, provided section 411(a)(10) requirements regarding vesting are satisfied. Furthermore, the proposed regulations would permit elective transfers to be made to plans that are within or outside an employer's controlled group. The proposed relief, however, also includes some limitations. First, the transfers would need to be between plans of the same type (e.g., from a section 401(k) plan to another section 401(k) plan). Second, in the case of transfers from plans that are subject to the survivor annuity requirements under section 401(a)(11) and 417, the requirements would apply to the receiving plan with respect to the transferred amount in accordance with the transferee plan rules at section 401(a)(11)(B)(iii)(III). Finally, the proposed regulations would eliminate the elective transfer rules as applied to amounts that are immediately distributable, because, according to the preamble to the proposed regulations, the same result is available through the direct rollover rules at section 401(a)(31). The elective transfer rules, however, would continue to apply to amounts that are not eligible rollover distributions, such as after-tax employee contributions. This rule would apply to transfers between defined benefit plans, as well as those between defined contribution plans. In-Kind Distributions. The proposed regulations also clarify and modify the rules regarding the application of section 411(d)(6) to a right to receive a benefit distribution in kind from both defined contribution and defined benefit plans. Under the proposed regulations, if a defined benefit plan includes an optional form of benefit under which benefits are distributed in the medium of an annuity contract, that form of benefit could be modified by substituting cash for the annuity contract. With respect to defined contribution plans, the proposed regulations would permit the plan to be amended to replace the ability to receive a distribution in the form of marketable securities, other than employer securities, with the ability to receive a distribution in the form of cash. Furthermore, the proposed regulation would permit a defined contribution plan to limit a participant's right to an in-kind distribution, including employer securities and property that is non-marketable securities, to the specific types of assets in the individual's account at the time of the amendment.

4*** Written comments on the proposed regulations must be received by June 27, 2000. A public hearing on the proposal is scheduled for June 27, 2000; requests to testify and outlines of oral comments must be received by June 6, 2000. The Institute will be scheduling a conference call to discuss the contents of a comment letter. Russell G. Galer
Senior Counsel Attachment