COMMENT LETTER

August 28, 1998

Comment Letter on Proposed Anticutback Rules for Defined Contribution Retirement Plans, August 1998

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Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn.: CC: CORP: T: R (Notice 98-29), Room 5226
Washington, DC 20044

RE: Notice 98-29, Request for Comments on Section 411(d)(6) Relief Regarding Optional Forms of Benefit

Dear Sir or Madam:

The Investment Company Institute[1] writes to strongly support the issuance of "optional form of benefit" relief, such as that described in Notice 98-29. Simply put, relief from the Section 411(d)(6) anticutback rule will substantially benefit plan sponsors and plan participants.

As is noted in Notice 98-29, many defined contribution plans provide an unnecessarily complex menu of benefit payment options because of current Section 411(d)(6) rules. As a result of this complexity, employers incur unnecessary administrative costs and find it increasingly difficult to communicate benefit payment options to participants, who are often overwhelmed by a confusing menu of benefit payment options. Accordingly, both employers and plan participants would benefit enormously from Section 411(d)(6) relief that permits employers to design a rational, easy-to-understand benefit structure. Such relief would be especially beneficial to small employers using prototype plans.

For these reasons, the Institute urges the Service to adopt a rule that would provide employers with some flexibility in meeting their obligations under Section 411(d)(6) with respect to optional forms of benefit. In particular, we recommend 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. Such an approach would be easy to understand, implement and administer. In addition, the lump sum distribution option would promote benefit portability. The Institute also recommends that the Service expand the availability of elective transfers, which would likewise promote benefit portability and enhance participants' ability to manage their retirement assets.

Our more detailed comments follow. They include a discussion of why we believe relief under Section 411(d)(6) is important, our specific recommendations for such relief, responses to particular items covered in Notice 98-29, including suggestions for more limited relief, and our recommendation regarding elective transfers.

The Importance of Section 411(d)(6) Relief

The anticutback rule currently operates in such a fashion as to impose unnecessary burdens on employers and greatly complicates matters for plan participants. This is best illustrated by two examples: (1) the accumulation of multiple payment options that occurs in the prototype plan environment, and (2) the complexities that arise in administering accrued benefits frozen to preserve optional forms of benefit under the current rule.

Prototype Plans. When employers that adopt plan prototypes change service providers, they also typically adopt the new provider's prototype plan. [2] Two situations may arise. First, as the Service observes in Notice 98-29, the new provider's prototype may offer a different menu of benefit options than the prior prototype. If the employer switches to the new prototype, under Section 411(d)(6) it is required to preserve the preexisting optional forms of benefit for benefits accrued up to the date of change in the prototype, resulting in administrative complications and an undesirable benefit structure.[3]

Alternatively, in an effort to avoid this problem, a service provider may offer a prototype product that is designed to assure that they can replicate any employer's menu of benefit payment options. As a result, however, employers often are presented with a large array of optional forms in a prototype product and tend to select more than might be necessary. In fact, many employers simply elect to provide all available options. Over time, this results in a complex menu of benefit payment options, leading to an increase in administrative burden, unnecessary participant confusion and additional plan expenses, which are frequently paid by participants.

This behavior, in part, reflects an extremely cautious approach to Section 411(d)(6) compliance. Small employers, who do not have the human resources capability to design, develop and maintain their own customized plans, are the typical users of prototype products. They are less likely to have ready access to historical records regarding their plans and, therefore, more likely to feel the need to "overcomply" with Section 411(d)(6) by providing participants with a full, if unnecessary and redundant, menu of benefit payment options.

Permitting greater flexibility under the anticutback rule would enable employers to (1) rationalize and simplify benefit options by reducing Section 411(d)(6) compliance concerns, (2) reduce administrative complexity and burdens, (3) reduce errors in communicating benefit options, and (4) deliver a better retirement plan product to participants. Moreover, prototype sponsors themselves would have less need to provide every possible benefit payment option as part of their prototype product.

Freezing plan benefit options. One method employers use to "avoid" encumbering their plans with multiple benefit forms is to freeze accrued benefits and establish a new, simplified form of benefit structure applicable to prospective benefit accruals. This method of Section 411(d)(6) compliance is frequently used in the context of corporate mergers and acquisitions, where an employer seeks to consolidate the plans of previously separate workforces.4 As noted above, employers changing prototypes also may find themselves in a similar situation.5

Freezing accrued benefits, however, significantly increases recordkeeping and other administrative obligations. Employers must maintain separate records for the previously accrued and prospectively accruing benefits, apply different payout rules to different portions of any one individual’s benefit, and maintain separate benefit descriptions and election forms for each portion of the benefit. They also must spend more time explaining benefit payout options to participants, often in one-on-one sessions.

Freezing accrued benefits, not surprisingly, is confusing for participants. Some participants will have different benefit payment options for different parts of their benefit and may need to make separate elections on separate forms. Moreover, some participants will have different benefit payment options than others. Thus, while the anticutback rule is intended to protect participants, in its application to optional forms of benefit, it frequently results in confusing them.

The following hypothetical example illustrates the difficulty: consider an employer with two defined contribution plans, Plan A for one group of employees and Plan B for a second group. Each plan has four benefit options, none of which are identical, except for the lump sum option each plan provides. The employer freezes benefit accruals in each plan—and establishes a single plan for prospective benefit accruals. As a result, the employer must maintain separate forms of benefit options (and, therefore, separate election forms and segregated assets) for the prior accruals of the Plan A and Plan B populations until the last vested participant in each plan retires.6

Recommendations for Form Of Relief

General Approach. The problems with the manner in which the anticutback rule currently is applied to optional forms of benefit—as illustrated by the examples above—argue strongly in favor of the adoption by the Service of a flexible, easy-to-understand rule that will enable employers to determine the specific type and number of benefit payment options most suitable for their workforce. The Institute believes that the best way to accomplish this objective would be for the Service to adopt a rule that would permit employers to reduce the number of benefit payment options their defined contribution plan provides to two: a lump sum distribution option and any one "extended form of payment option"—regardless of whether that particular extended form was previously offered in the retirement plan.

Lump Sum Distribution Option. A lump sum distribution option is perhaps the single most significant form of benefit provided in a defined contribution plan. A lump sum option provides each individual participant with maximum flexibility, because the participant is able to take the lump sum and provide him or herself with any other form of benefit. For instance, a participant may roll a lump sum into another retirement vehicle such as an IRA and take distributions over time as he or she deems appropriate—either in a payment stream of his or her choice or by purchasing an annuity or other extended form of payment product that produces a payment stream and/or guaranty that suits his or her needs. Indeed, because participants have the ability to take a lump sum and replicate any other optional form of benefit that may have been offered in a plan, the elimination of other optional forms of benefit should not result in the loss of a "valuable right" under Reg.

1.411(d)-4 Q&A 2 at A-2(b)(1). Put another way, the only benefit form that must be preserved to assure that participants are sufficiently protected under the anticutback rule is the lump sum distribution option.7

Extended Forms of Payment. The Service has proposed relief that would require employers to preserve at least one "extended form of payment" option. While the Institute believes, based on the foregoing analysis, that such a requirement is unnecessary under Section 411(d)(6), we offer our thoughts on the contours of such a rule.

First, to implement a requirement that employers eliminating optional forms of benefit provide at least one "extended form of payment" option, the Service must define the term "extended form of payment." The best and simplest approach to the issue of definition is to define an extended form of payment as "any form of payment other than a lump sum." An alternative would be to provide a minimum extended payment period, such as ten years.8

Most importantly, the Service should avoid establishing a hierarchy of extended forms of payment. Instead, it should permit an employer to select any extended form of payment—regardless of whether or not it had been offered under its plan. In Notice 98-29, the Service outlines three types of extended payment forms that would be considered "extended forms of payment": (a) single or joint life annuity (b) installments payable over a single or joint life expectancy, and (c) installments payable over the longest installment period permitted under the plan. The Service also indicates that it might rank these forms of payment, preferring annuities over installments and longer payment streams over shorter ones.

We see no need to establish such a hierarchy. Employers—not the Service—are in the best position to determine which "extended form of payment" option is best suited to their workforce. For example, if the Service were to structure its relief to require an employer to continue to provide the longest installment period option, that may not necessarily be the best outcome for participants. That benefit option might have been the least used option; thus, to require it to be the extended payment option would leave participants to choose only between a lump sum and what had been an unpopular benefit choice. Or, that option might be an anomaly, one that exists only as a result of corporate acquisitions, related plan mergers, and the need to comply with Section 411(d)(6). Any rigid "hierarchy" of benefits is apt to lead to similar problems. Thus, the Institute strongly recommends that the Service permit employers to establish sensible benefit options appropriate for their current workforce.

Protecting Individuals Near Retirement. In granting relief under the anticutback rule, the Service must consider the need to protect participants who are at or near retirement. Although, based on our analysis, any of these participants will be able to replicate any benefit form eliminated if provided with a lump sum, participants at or near retirement may have developed a significant reliance interest in a plan-provided benefit option and may have initiated financial plans for retirement based on the availability of a specific plan-provided benefit form. Such reliance should be taken into account in the Service's relief. The Service similarly considered the needs of this population in its recent guidance implementing Small Business Job Protection Act changes to the minimum required distribution rules. Similar concerns are present here and similar protections should be in place. In Notice 98-29, the Service suggests that a plan amendment eliminating or restricting the availability of optional forms of benefit would not be permitted to apply to a participant whose distribution began before the date of the amendment or will begin within 90 days thereafter. The Institute agrees that this protection is necessary and appropriate.

Alternative Approaches. The Service also has invited comments on more limited forms of relief. Specifically, the Service seeks comment on relief that would permit employers to eliminate optional forms of benefit where either (1)participant utilization of the optional form is demonstrably low; (2) the optional form applies to only a small portion of participants' benefits, or (3) the effective date of elimination of the optional forms is deferred for a period of years. Given the inflexibility of the current rule, Institute members would welcome any relief. The alternative approaches, however, would limit the availability of relief to significantly fewer plans than the approach described above. Further, the alternatives may require complicated rules, tests, or standards making them significantly less desirable. If the Service, however, determines not to implement the general approach described above, it should consider using a combination of the alternative approaches set forth in Notice 98-29, as each alone may not be applicable to a sufficient number of plans.

Low Participant Utilization Rates. As the Service observes in Notice 98-29, an approach that permits employers to eliminate only optional forms of benefit with respect to which participant utilization is demonstrably low raises "issues of substantiation." The concept of a "low utilization" rate would need to be defined, presumably by some numerical standard or test. Similarly, the group of participants to which the test would apply also would need to be defined. Because anticutback rule concerns frequently arise in the context of merged plans, it may be quite difficult to design an adequate, uncomplicated rule. There also may be plans with a relatively young participant population in which it is likely that only a few individuals, if any, have reached retirement age and had an opportunity to select among the optional forms. Presumably, a "low utilization" rate approach makes little sense for such plans.

Assuming these and other issues are resolved, many employers may not be able implement the testing standards in a cost-effective manner. Some employers may not have ready access to information regarding distribution patterns and, therefore, may not be able to take advantage of the relief. This may be a significant problem for employers that have been involved in mergers and acquisitions activity (and, thus, are without easy access to a predecessor corporation's benefits records), small employers, who do not have the personnel available to collect and review historical distribution information, and employers that have changed recordkeepers.

Small Portions of Benefit Effected. Implementation of this alternative may give rise to complicated standards and testing. If the Service adopts this approach, it should make the rules as simple as possible, such as by establishing a "bright line" test under which employers could determine whether or not only a "small portion" of benefits would be effected by the elimination of an optional form of benefit. For instance, the elimination of an optional form of benefit might be permitted only in cases where no more than twenty percent of the aggregate value of all accrued benefits would be effected.[9] Additionally, the Service would need to make clear on which dates the relevant test would be performed and determine the methodology by which benefits would be valued.

This approach takes into account plan assets on a plan-wide basis. As a result, any particular participant could be in the position of having a relatively large portion of his or her accrued benefit affected, regardless of whether a plan-wide testing standard is satisfied. A participant-by-participant approach to testing, however, would be unfeasible. One possible solution would be to require satisfaction of a second standard, by, for instance, requiring that the optional benefit eliminated be applicable to less than a certain percentage of all relevant participants.

Finally, the Service should consider the extent to which this approach would provide adequate relief. One situation for which this approach appears to be particularly well-suited is in the context of a merger or acquisition, where a larger employer has taken over a smaller employer. It may be less useful, however, for many other employers.

Delayed Effective Date of Elimination of Optional Forms. An approach that would permit employers to eliminate optional forms of benefit if the effective date of the elimination is delayed for "some period of years" has the benefit of being much simpler to implement than the two alternatives discussed above. One serious shortcoming, however, is that it would defer implementation of relief that would immediately simplify plan administration, lower plan costs, and provide a more coherent, understandable benefit program to participants. If the principal reason to delay the elimination of optional forms of benefit is to protect participants that are relying on the plan's provision of these particular forms, the time frame for implementation recommended above would seem to address this issue. This approach also leaves open the question of which optional forms may be eliminated and which must continue to be provided.

Elective Transfers and Other Issues

Elective Transfers. The Service also states that it is considering providing additional relief in the context of elective transfers between defined contribution plans. As is noted in Notice 98-29, employees transferred between employer businesses with different retirement plans often are unable to easily transfer their accrued benefit from one plan to another. Similar issues arise as a result of the "same desk rule," which applies to 401(k) plans. This rule frequently—and unfairly—frustrates employees seeking to consolidate account balances within the plan of their current employer. This results in an unnecessary "employee relations" issue for employers.

The Section 411(d)(6) regulations currently provide a special "elective transfer" rule that permits elective transfers between plans to the extent each transfer is conditioned upon a "voluntary, fully informed election by the participant" (Reg. 1.411(d)-4 Q&A 3 at A-3). The rule, however, requires that the benefits be distributable under the terms of the plan from which they are being transferred (Reg. 1.411(d)-4 Q&A 3 at A-3(b)(1)(ii)) and, therefore, is inapplicable to many situations where it would be most useful. Where the elective transfer rule is inapplicable, the general anticutback prohibitions apply,[10] creating a significant barrier to benefit portability and benefit consolidation for employees and significant administrative burdens for employers.

For these reasons, the Institute urges the Service to expand the elective transfer rule to permit transfers of benefit between all defined contribution plans (regardless of type of plan).

Time Frame In Which Guidance May Be Issued. As the Service recognizes, many retirement plans will be amended and restated to comply with the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997. The Service should consider making Section 411(d)(6) relief, if any is issued, available in a time frame that will enable employers and prototype sponsors to make plan amendments eliminating optional forms of benefit in conjunction with amendments necessitated by SBJPA '96 and TRA '97.

Conclusion

The Institute believes that relief from the anticutback rule is necessary to permit employers to maintain rational, easy-to-understand benefit payment options for participants. The current rule, while well-intentioned, has confused participants and imposed unnecessary administrative burdens. The Service could address these problems and still ensure the preservation of benefits for participants by adopting a rule that grants employers the flexibility to easily implement a simplified menu of benefit payment options that best fits the needs of their workforce. Finally, expanded availability of the "elective transfer" provisions would assist employers seeking to simplify their retirement plans, reduce administrative complexity and enhance benefit portability for participants.

Sincerely,

Russell G. Galer
Senior Counsel

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includescompanies 7,301 open-end investment ("mutual funds"), 436 closed-end investment companies, and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.097accounting trillion, for approximately 95% of total industry assets, and have over 62 million individual shareholders. As of yearend 1997, the Institute has estimated that over 40% of all 401(k) plan assets are invested in mutual funds. In addition to serving as the investment vehicle of choice for many retirement plans, mutual funds and their affiliates offer a full range of recordkeeping, administrative, and trust services to plan sponsors. Many sponsor prototype plans.

2 It is not unusual for employers to change service providers. Estimated annual bundled service provider turnover rates are 9% for small employers of under 100 employees, 12% for medium employers with 100-1000 employees, and 11% for large employers with over 1000 employees. "SPARK Marketplace Update," Access Research, Inc. (1996). Similarly, a 1995 RogersCasey/IOMA defined contribution plan survey found that in the past year 22% of plans hired new investment managers, 15% a new trustee, and 18% a new recordkeeper.

3 This situation presents issues identical to that which arise when "freezing" plan benefit options, discussed below.

4 See Reg. 1.411(d)-4 Q&A 2 at A-2(a)(3)(i), which discusses the anticutback rule as applied to optional forms of benefit in the context of plan mergers and benefit transfers.

5 Similar issues arise with respect to in-service distribution options, which are not addressed in Notice 98-29. The Service should consider expanding relief to address them. Preserving in-service distribution options, such as the right to make withdrawals of employer contributions after a fixed number of years, for example, is particularly difficult when merging one plan into a plan that does not have those features. Such withdrawal rights are not uncommon in profit-sharing and thrift plans established before the 1980s. It is very unusual, however, to find such rights in a prototype plan or a more recently established plan. Maintaining or freezing such rights burdens employers with the same burdens they face in preserving optional forms of benefit. Participants, however, may be protected from loss of a valuable right, however, where a plan sponsor adds a loan

provision in place of such rights. Furthermore, the Service already allows the elimination of in-service hardship withdrawal provisions. See Reg. 1.411(d)-4 Q&A 2 at A-2(b)(2)(x).

6 Despite the fact that over time a Section 411(d)(6) protected form of benefit will apply to a decreasing percentage of various employees' benefits and to a decreasing percentage of the plan assets as a whole, the form of benefit must be preserved with regard to previously accrued benefits. See Reg. 1.411(d)-4 Q&A 1 at A-1(b)(2), Example 7.

7 There is some precedent for this position. The Service already has recognized, in certain instances, that the elimination of optional forms of benefit and the provision of only a single lump sum payment will not violate Section 411(d)(6). See Reg. 1.411(d)-4 Q&A 2 at A-2 (b)(vi) regarding involuntary lump sum distributions from terminating profit-sharing plans.

The availability of a lump sum distribution option enables individuals to decide how much, if any, of their wealth to annuitize at retirement. Because of the cost of annuities, many individuals may be better off delaying annuitization of assets until well after normal retirement age. As one economist has observed, "it makes very little sense for consumers under the age of 80 to annuitize . . . .[except] in the event that interest rates are extraordinarily high (cheap annuities) or when the consumer has private information that would lead him or her to believe that they are much healthier than the general population." Moshe Arye Milevsky, "Optimal Asset Allocation Towards The End of The Life Cycle: To Annuitize or Not To Annuitize" (working paper, York University, July 1997). See also Congressional Budget Office, "Social Security Privatization and The Annuities Market," February, 1998 (observing "unfavorable pricing of private annuities as result of market imperfections.")

8 A ten-year requirement would be consistent with concepts underlying the definition of an "eligible rollover distribution." An eligible rollover distribution is any distribution except for one of substantially equal periodic payments made over life, life expectancy or for a specified period of ten years or more. Code Section 402(c)(4).

9 The twenty percent standard is based on the standard that applies in the context of "partial terminations."

10 Section 411(d)(6) regulations generally prohibit such elections that waive Section 411(d)(6) protected benefits. "A plan may not be amended to eliminate or reduce a Section 411(d)(6) protected benefit that has already accrued. . . . This is generally the case even if such elimination or reduction is contingent upon the employee's consent." Reg. 1.411(d)-4 Q&A 2 at A-2(a)(1). See also Reg. 1.411(d)-4 Q&A 3 at A-3(a)(3) ("In general, an employee may not elect to waive Section 411(d)(6) protected benefits.").