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# Testimony before the ERISA Advisory Council's Working Group on Spend Down of Defined Contribution Assets at Retirement

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Good morning. My name is Joan Gucciardi and I am a senior consulting actuary with Summit Benefit & Actuarial Services, located in Eugene, OR and Wauwatosa, WI. Our firm specializes in providing actuarial, consulting and administrative services for small business retirement plans. I also co-author a book, the *Pension Distribution Answer Book*, that deals with the current laws and regulations regarding distributions from qualified plans.

I am here today to present the view of ASPPA, where I currently serve as a member of the Government Affairs Legislative Relations Committee. ASPPA is a national organization of more than 6,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants and attorneys. Our large and broad-based membership gives ASPPA unique insight into current practical applications of ERISA and qualified retirement plans, with a particular focus on the issues faced by small- to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the employer-sponsored retirement plan system.

ASPPA applauds the Council's leadership in examining the extremely important issue of the need for participants to manage their retirement assets effectively post-employment, along with the acceleration in the development of investment and insurance products that can be offered within or outside of DC plans to guarantee basic levels of income for participants at retirement.

**Summary**

My focus today will be on ideas that will make retirement savings last longer and assist in ensuring that a defined contribution plan participant and his or her spouse will not outlive retirement assets. These changes fall broadly into two categories – encouraging retirees to manage retirement funds wisely, and encouraging pre-retirees to not spend retirement savings before actually reaching retirement. Plan sponsors can facilitate this process by design changes to their defined contribution plans, making them "leakage-proof" or at least minimizing the leakage possibilities. Legislative changes, both to ERISA and the Tax Code, are also needed to permit a number of these ideas.

**Recommendations**

**<u>Encourage plans to allow partial lump sums and partial annuity options</u>**

Although not legally required, most defined contribution plans require a participant to choose a single option for payment of his/her benefit. If a plan allows a form of benefit other than a lump sum, the plan document will likely require that the choice for distribution be an “all-or-nothing” proposition. For example, a participant may be allowed to elect five annual distributions of his/her account balance, but would not be allowed to choose a single sum of 50% of his/her account balance and then five annual distributions of the remaining balance.

**Proposed Change**

Encourage plans to offer participants the opportunity to elect a portion of their benefits in a lump sum/IRA rollover and a portion (a minimum percentage or dollar amount) as an annuity or a set of fixed payments.

**Reason for Change**

Even when participants prefer a lifetime guarantee, it is difficult for them to commit 100% of their benefit to an annuity payment. There is a psychological desire to have a portion available as needed for unanticipated living expenses or for the initial expenses of the transition to retirement.

**<u>Encourage annuity options</u>**

The current law requires that defined benefit plans, money purchase plans and transferred money purchase accounts provide a qualified joint and survivor annuity and qualified pre-retirement survivor annuity as the default option for participants married for at least one year before the annuity starting date. However, current law eliminates the above requirement for profit sharing/401(k) plans so long as 100% of the death benefit is paid to the spouse (assuming that the spouse does not waive death benefits) and the plan does not offer an annuity as an optional form of benefit.

**Proposed Change**

401(k)/profit sharing plans should be encouraged to offer annuity options, which would make the qualified joint and survivor annuity the default option for these plans, and require spousal consent for lump sums. A key component of encouraging 401(k) plans to voluntarily adopt the QJSA option is to allow electronic consent under these arrangements. A suggested mechanism would be for the spouse to register his/her signature at the time of initial participation/change in marital status. When the participant is eligible for distribution and elects a lump sum, the spouse could then electronically consent to the lump sum.

**Reason for Change**

401(k) plans have generally replaced DB plans as the primary source of retirement income, and most participants do not have access to annuity options in their 401(k) plans. This means many retirees do not have the opportunity to protect themselves from outliving their retirement assets within the

401(k) plan itself. The retiree could purchase an annuity within an IRA, but such an individual annuity would likely be quite expensive.

The creators of ERISA and REA saw spousal protection in the form of the QPSA and QPSA as a critical piece of a participant's retirement security in the most prevalent plan of the time, defined benefit plans. Removing roadblocks to offering an annuity option in 401(k) plans would help protect non-working spouses or spouses that have non-continuous work history.

**<u>Allow for advance IRA designation for defined contribution plans</u>**

Automatic enrollment is taking advantage of participant inertia in helping participants accumulate funds for retirement. This idea would do the same thing for reducing leakage from the system. Under current law, upon termination of employment or other distributable event, participants make elections on how to dispose of their vested account balance from a qualified retirement plan. Before receiving a distribution, a participant must be furnished a tax notice under Code Section 402(f) within 30 to 90 days prior to receiving his or her distribution.

**Proposed Change**

Allow participants to make a revocable IRA designation at the time the employee enrolls in a defined contribution plan and also at the time the plan sponsor might move to a new investment provider. If within 90 days following termination of employment, the participant does not make a different election or revoke the existing election, the employee's vested balance would be automatically rolled over to the designated IRA.

This would be an optional plan feature. Plans offering this feature would be required to offer participants reasonable opportunities to revoke or change their election. Participants would be provided the information contained in the 402(f) notice at the time of enrollment.

This proposed change would not apply to plans that are subject to the joint and survivor rules or plans that otherwise require spousal consent for distributions. In other words, the QJSA safeguards would not be overridden by this change.

**Reason for Change**

Allowing participants to designate an IRA at the time that they enroll in defined contribution plans would encourage participants to roll over their vested account balance to an IRA and reduce leakage from the retirement system. It would also promote participants' consolidating their retirement assets in fewer accounts, which would make it easier for participants to manage and monitor their retirement assets.

**<u>Long-term care insurance (LTCI)</u>**

Currently, existing retirement savings cannot be used on a pre-tax basis to provide for long-term care. In fact, amounts may not be able to be withdrawn from the retirement plan before age 59½ or severance of employment.

**Proposed Change**

Permit tax-free distributions to participants from defined contribution plans, 403(b) plans, governmental 457(b) plans and IRAs if the proceeds are used to purchase qualified long-term care insurance on behalf of themselves, their spouse, their dependents or a "qualifying relative" (as defined in Code Section 152(d)(1)(A), which includes parents, siblings and domestic partners). The proposal would limit annual distributions to purchase qualified long-term care insurance to five percent of the participant's total account balance or specified dollar amounts that should be age dependent. Distributions under this proposal would not be subject to the withdrawal restrictions otherwise applicable to the plans referred to above.

**Reason for Change**

Long-term care insurance is a retirement savings protection mechanism. By acquiring this insurance when an individual is in his/her 50s or earlier, LTCI is affordable and can protect against both the rapid deterioration of retirement savings and the escalating costs of assisted living. Allowing the withdrawal on a pre-tax basis will minimize the reduction in retirement savings.

**Exempt small balances from minimum required distribution (age 70½) calculations**

As life expectancy continues to improve in the US (now over age 78 on the average), the 2008 Retirement Confidence Survey indicates that, on average, workers of all ages appear to be planning to retire later than similarly aged workers were a decade ago, with an increased percentage planning to retire at age 66 or older for almost every age group. Of those responding, nearly all indicated they intended to continue working to make ends meet. Unfortunately, the minimum required distribution (MRD) requirements do not support these older individuals in efforts to preserve their retirement savings until needed. Although the rules do not require actually taking the funds out of savings (as opposed to simply removing them from a tax favored vehicle), many, if not most, retirees over age 70½ probably interpret the rules as a signal to comply with the rules by withdrawing the funds from their savings.

These rules impose a real administrative burden to both plan sponsor and participant where small balances exist.

> Example. Sally has a 401(k) balance of $25,000 and a joint life expectancy of 25 years. She terminates employment, but chooses to leave her balance in the 401(k) plan. She would be required to take a $1,000 distribution from the plan. Even a modest $100 or $150 administrative processing fee for the MRD represents 10-15% of the distribution itself.

Lower-income participants with small balances who are caught in this trap are often forced to pay significant distribution fees before funds are truly needed. Distribution fees are usually independent of the account balance. For larger MRD distributions, this fee represents a much smaller percentage.

The current rules (including a 50% excise tax payable by the participant for failure to receive the MRD) are designed, in large part, to restrict individuals from transferring the majority of their benefits from their tax-deferred retirement savings to a subsequent trust or generation at their death. Participants with relatively small balances are not the group for whom this provision was targeted. Yet they are the most likely to lose contact inadvertently with their former employer; if they fail to receive this distribution, it comes at a very high price.

**Proposed Change**

Exempt any individual whose aggregate balance in his or her eligible retirement plans (and health savings accounts) does not exceed $50,000 from the minimum required distribution requirements of Code Sections 401(a)(9), 408(a)(6) and 408(b)(3).

Delay the application of these rules to individuals whose aggregate balances fall between $50,000 and $200,000 by one year.

For purposes of determining the aggregate balance, income annuity contracts with no cash surrender value are not taken into account. Distributions from the annuity contract will, however, apply towards satisfying the minimum required distribution for the year.

**Amend 401(a)(9) to allow for longevity insurance**

Longevity insurance is available in the market place for individuals in the form of deferred annuity. Generally, the deferral (or starting) age is somewhere between ages 80 and 85. This product generally has no cash value if surrendered before the deferral age. Some insurers, however, have recognized that this product might not be attractive to individuals, so additional features have been added:

1. A death benefit to be paid to heirs,
2. Early payments for nursing home care,
3. Cash withdrawal options, and
4. Inflation protection.

Of course, the price of these additional features means a reduced benefit payable at the deferral age.

**Proposed Change**

Amend Code Section 401(a)(9) to allow for purchase of longevity insurance.

> Example: Joe, a 65 year old employee, retires and elects to roll over 90% of his account balance to an IRA. The remaining 10% is used to purchase a deferred to age 85 annuity. He has taken the vast majority of his balance to invest as he sees fit. In the event he lives to age 85, however, he will begin to receive a monthly annuity. This provides him some protection from outliving his assets and/or being unable to manage his assets as he ages.

Allow this type of deferred annuity as an optional form of payment in qualified plans.

**Reason for Change**

These annuities cannot be purchased or used effectively inside qualified plans or IRAs because of the restrictions imposed by Code Section 401(a)(9).

**Eliminate active employee access to benefits at plan termination**

Under current law, Code Section 411(d)(6) protects optional forms of benefits from being eliminated by plan amendment, including an amendment to terminate a plan. Thus, a qualified plan that offers a lump sum distribution option for participants at retirement or other severance from service is obligated to offer a lump sum option to all (active or vested terminated) participants at the time the plan is terminated, even though, absent the termination of the plan, no distributable event would have occurred.

If the plan sponsor wishes to eliminate active employee access to their retirement accounts/benefits, the plan assets must be transferred directly to a successor plan through a trust-to-trust transfer. Such a transaction requires the receiving plan to retain the distribution options provided by the predecessor plan with respect to the contributions/benefits attributable to the originating plan.

Absent a plan merger/restatement or trust-to-trust transfer, there is no mechanism allowing the employer to avoid making those accounts/benefits available to their active employees or to compel them to roll the accounts directly to a successor plan or IRA.

**Proposed Change**

Modify current law applicable to terminating plans with lump sum distribution options to:

1. Eliminate the obligation to offer active employee participants a lump sum cash distribution.
2. Enable these participants to receive their lump sum distribution only by electing either:
   (a) A direct rollover to an IRA, or
   (b) A direct rollover to another plan (including a successor plan of the employer) with no Code Section 411(d)(6) protection of the optional forms of benefits from the originating plan.
3. If a participant cannot be located or fails to make an election, the plan sponsor may choose as a default procedure either the direct IRA rollover or rollover to a successor plan.
4. Dollars transferred by an active employee to an IRA through a direct rollover at plan termination would be restricted from withdrawal for a minimum of two years unless the employee turns age 59 ½ during the two year restriction period. In addition, if the rollover includes elective deferrals, the amount of deferrals shall be available in the event of a hardship, provided the IRA provider offers such a hardship option. Any default IRA used for distribution of 401(k) deferrals would be obligated to contain a hardship option.
5. De minimis amounts (*e.g.*, $1,000, indexed) would be permitted to be distributed in cash to the participant.

**Reason for Change**

The event of terminating a plan should not, in of itself, provide access to qualified plan benefits for employees who have not severed employment with the plan sponsor or met one of the plan's retirement age conditions. As the incidence of employer mergers, spinoffs or simple changes in style of plan offered to their employees, plans are terminated to allow consolidation of accounts and plan administrative procedures. For a number of reasons (including the administrative burden of retaining prior distribution options), a formal plan termination is, most often, the preferable approach. This provides significant and unnecessary opportunity for leakage of retirement assets out of the system.

**<u>Allow IRAs to accept rollovers of 401(k) loan balances to accept recurring payments</u>**

When a participant terminates employment, his/her loan balance generally becomes due. In limited cases, a participant may roll over his/her existing loan balance to his/her new employer's plan. This rollover of an existing participant loan is not available in the case of an IRA rollover.

**Proposed Change**

Allow IRAs to accept a rollover of the loan balance and periodic loan repayments so that this money will remain in the loan system.

**Reason for Change**

In most cases, when a participant terminates employment, the loan becomes due immediately, and the participant is forced to either immediately repay the loan or be subject to tax on the outstanding loan balance, including any applicable early distribution penalties. This is a significant portion of retirement plan leakage. By permitting IRAs to accept existing loans, the amount of leakage can be reduced.

**Biography of Joan Gucciardi**

Joan Gucciardi, MSPA, MAAA, EA, CPC, CLU, ChFC, is a Senior Consulting Actuary with Summit Benefit & Actuarial Services, Inc. She has been an Enrolled Actuary under ERISA since 1976. She has co-authored *The 401(k) Answer Book* (1992), *5500 Preparers' Manual* (1993-2001), *The Pension Distribution Answer Book* (2008), *The Plan Termination Answer Book* (2008) and *The Pension Answer Book: Special Supplement: Cash Balance Plans* (2003). She is Co-Editor-in-Chief of *The Journal of Pension Benefits* (Panel Publishers, 1993-2008). She received ASPPA's Educator's Award in 2002.