TREASURY FACT SHEET: HELPING AMERICAN FAMILIES ACHIEVE RETIREMENT SECURITY BY EXPANDING LIFETIME INCOME CHOICES

In September 2009, President Obama announced several new steps to make it easier for American families to save for retirement, including expanded opportunities for automatic enrollment in 401(k) and other retirement savings plans, and improved ways to save tax refunds. In addition, the President has put forward a legislative proposal for automatic Individual Retirement Accounts (IRAs) in which tens of millions of workers who have no employer-sponsored retirement plan would automatically participate through payroll deposit contributions at the workplace, while remaining free to opt out.

Increasing saving is vital to improving Americans' retirement security; equally important is how people use their savings. Particularly as the baby boomers approach retirement, and as life expectancies and retirement periods lengthen, Americans are increasingly confronting the risk of outliving their assets in retirement ("longevity risk") and are seeking more help and better strategies for managing their savings in retirement. Women are particularly exposed to longevity risk because their life expectancies exceed those of men. (For example, a 65-year-old woman is projected to have an even chance of living past age 86, while her male counterpart is projected to have an even chance of living past age 84.[1])

Managing longevity risk is a challenge. While we know average life expectancies, it is difficult or impossible for particular individuals to know how long they will live. As a result, many retirees are exposed to the risk of outliving their savings or, alternatively, unnecessarily limiting their spending in retirement because of the fear of outliving their savings.

Traditionally, the most comprehensive solution to the challenge of managing retirement savings to achieve retirement security has been to replace the paycheck retirees received when they were active workers and protect them from outliving their assets through a guaranteed and predictable stream of lifetime income, such as a defined benefit pension. Another source of such retirement income has been a life annuity provided through a defined contribution plan, an IRA, or otherwise. Lifetime income can be a valuable way for retirees to protect themselves from financial risks, especially the risk of outliving their savings.

Yet over time the use of annuities and other lifetime income in retirement plans has been diminishing. Unfortunately, defined benefit pension plans, a traditional source of low-cost lifetime income, have declined; and defined benefit plans have increasingly offered and made single-sum (or "lump sum") cash payments, either by adding a lump-sum option to the plan's payout choices or by converting the plan to a "hybrid," lump-sum-oriented format. (Out of $11.2 trillion of private pension assets in 2011, only 21 percent were maintained in defined benefit plans, with the remainder held in defined contribution plans (36 percent) and IRAs (43 percent).)[2] In short, although the term "pension" traditionally has referred to a regular stream of income guaranteed for life, the nation's private pension system has been steadily shifting away from lifetime retirement income payments to single-sum cash payments.

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[1] 2011 Annual Report of the Social Security Trustees, page 93, Table V.A4 (intermediate assumptions).

[2] Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Statistical release Z.1 (December 8, 2011). These figures exclude plans for Federal, State and local governmental employees.

To help address these issues, the Treasury and Labor Departments have undertaken an initiative to give employees and employers more options for putting the "pension" back in our private pension system. The initiative has included a joint request for information (RFI) from the public regarding the desirability and availability of lifetime income alternatives in retirement plans. The joint RFI elicited nearly 800 written comments from a wide range of organizations and individuals. Many comments suggested that the Departments encourage broader availability of secure and attractive retirement income options. The Departments then held a two-day public hearing to learn more, including about whether current rules or regulations present any unnecessary impediments to plan sponsors and participants who might choose retirement income.

After reviewing the comments, Treasury and the Internal Revenue Service (IRS) are releasing an initial package of proposed regulations and rulings intended to remove impediments and otherwise ease the offering of lifetime income choices that can help retirees manage their savings.

Today's administrative guidance is only a first step in clearing the way for better and more accessible retirement income options; it does not attempt to address all of the issues raised by public comments in response to the joint RFI. However, it is a meaningful first step – reducing regulatory barriers in order to increase interest in lifetime income, encourage innovation among stakeholders, and expand choices for individuals with a view to promoting greater retirement security for American families.

Today's guidance is expected to be followed by continued dialogue and further retirement income guidance from both the Treasury and Labor Departments later this year.

To summarize, the new package of proposed regulations and rulings makes it easier for pension plans to offer workers a wider range of choices as to how to receive their retirement benefits by–

- Making it easier to offer combination options that avoid an "all-or-nothing" choice, such as the option to take a portion of an individual's plan benefit as a stream of regular monthly income payable for life, while perhaps taking the remainder in a single lump-sum cash payment;

- Enabling employer plans and IRAs to offer an additional option in the form of "longevity annuities" – which permit employees to use a limited portion of their account balance to provide lifelong retirement income beginning at age 80 or 85, protecting those who live beyond average life expectancy from running out of savings;

- Making clear that employees receiving lump-sum cash payouts from their employer's 401(k) plan can transfer some or all of those amounts to the employer's defined benefit pension plan (if the employer has one and is willing to allow this) in order to receive an annuity from that plan (giving employees access to the defined benefit plans' relatively low-cost annuity purchase rates); and

- Resolving uncertainty as to how the 401(k) plan spousal protection rules apply when employees choose deferred annuities (including longevity annuities) from their plans.

This package offers assistance with respect to various kinds of plans – defined benefit pension plans, 401(k) and other defined contribution plans, and IRAs – while opening windows for innovation by plan sponsors, insurers, and other financial providers.

Specifically, here is how the new guidance gives workers and retirees, employers, and providers of retirement and financial services additional options to provide for lifetime retirement security:

1. Making It Easier to Offer the Option of Partial Annuities

One reason more plans do not offer lifetime income options is that some plan sponsors perceive a low level of demand on the part of their employees. Today's guidance helps address this in several ways.

First, one reason many employees decline annuity choices and take their entire pension benefit in the form of a single lump-sum cash payment may be the perception that they are confronting an all-or-nothing choice. While plans typically permit employees to receive their benefit in one of several alternative forms, many employees may prefer a combination of options. One potentially attractive combination would pay some of the benefit as a stream of income for life (to provide protection against the risk of outliving one's savings) and the rest of the benefit as a lump sum which provides liquidity. Many plans do not offer this type of option; even if a split option is available under a plan, the "choice architecture" a plan uses to frame employees' choices may fail to make that readily apparent. And if employees are faced with a choice between an annuity and a single-sum cash payment for their entire benefit, many – reluctant to invest everything in an annuity without also keeping flexible liquid assets – will opt for the cash.

The proposed regulations Treasury is issuing today would help by making it simpler and therefore easier for pension plans to offer retiring workers more choices. Plans could more readily offer split options that avoid an "all-or-nothing" choice, such as the option to take any portion of the plan benefit as a stream of lifetime income (while taking the rest as a lump sum which is rolled over to an IRA).

The proposed regulations would encourage split options involving lifetime income by simplifying the calculation of such bifurcated benefits. Plans generally are required to calculate the dollar amount of each full optional form of benefit available as a choice for retiring employees. Plans generally may use a simple method – the plan's regular conversion factors – to calculate the amount of each type of annuity by converting one type of annuity (such as a single life annuity) to another (such as a joint and survivor annuity payable to a retiree and his or her surviving spouse), but must use statutorily prescribed interest rates and mortality assumptions to calculate the amount of a lump sum or a similar accelerated benefit.

The regulatory barrier: Where an optional form of benefit consists of a split – partial lump sum and partial annuity – current regulations require the use of the statutorily prescribed actuarial assumptions (interest rates and mortality assumptions) for both portions. This means that the plan is unable to use its regular conversion factors to determine the amount of the partial annuity.

The solution: The rules proposed today would streamline the calculation of partial annuities. The statutorily prescribed actuarial assumptions would be required to apply only to the portion of the distribution being paid as a lump sum. Plans would be allowed to determine the remainder of the benefit – the partial annuity – using the plan's regular conversion factors.

> **Example:** If an employee elects to take 75 percent of his benefit as a partial annuity and 25 percent as a lump sum, the dollar amount of the partial annuity would simply be 75 percent of the previously-calculated dollar amount of the full annuity, and the partial lump sum would simply be 25 percent of the previously-calculated dollar amount of the full lump sum.

The simpler method of calculating partial annuities should make plans more willing to offer and emphasize the option of a partial annuity with a partial lump sum, rather than putting participants to an “all or nothing” choice to take their entire plan benefit in a single optional form.

2. Making It Easier to Offer the Option of Longevity Annuities

Another reason for the relatively limited demand for annuities is that the need for liquidity and flexibility makes many employees reluctant to part with all or most of their assets to provide lifetime income protection. To address these concerns, Treasury and the IRS are issuing proposed regulations today that would make it easier for defined contribution plans and IRAs to offer longevity annuity options.

A longevity annuity (sometimes referred to as “longevity insurance” or a “deeply deferred annuity”) is an income stream that begins at an advanced age, such as age 85, and continues as long as the individual lives. These annuities can provide a cost-effective solution for retirees who are willing to use part of their savings to protect against outliving the rest of their savings and feel reasonably confident that they can manage the rest of their savings until a fixed target date such as age 85.

Until now, however, longevity annuities generally have been little used in 401(k) or other defined contribution plans or in IRAs. A key reason for this is a regulatory obstacle posed by the minimum distribution requirements.

The regulatory barrier: Current law generally requires individuals to begin taking payouts from a qualified employer-sponsored retirement plan or IRA soon after reaching age 70 1/2. The person’s entire interest in the plan or IRA must be paid (in accordance with regulations) over the lives of the individual and his or her designated beneficiary. Current regulations require defined contribution plans and IRAs to determine the required minimum distribution by dividing the employee’s entire account balance in the plan by the employee’s life expectancy (or that of the employee and a designated beneficiary).

> **Example**: Bill is age 65 and has $200,000 in his 401(k) account. The plan offers Bill an annuity within the plan that does not begin until Bill would reach age 85, and Bill wants to use a portion of his account balance to purchase the annuity. Bill plans to use the remaining balance, together with Social Security and any other resources, to provide retirement income until the annuity starts.
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> Bill is uncertain how much he can prudently take out of the account every year because it depends on unknowns such as how long he will live and what the future investment earnings will be. Bill also feels it would be easier if he only had to manage his balance to last for a fixed period of years – until a specific target date – rather than for an uncertain life span. He could use the entire balance to purchase a life annuity, but wants to keep control over most of the balance and keep it available to meet unexpected expenses and for opportunities that might arise.

Current regulations would require that the value of that annuity be counted in calculating the required minimum distribution each year before the annuity begins. This could pose a problem if Bill's spending from the remaining balance in his account does not leave enough to make minimum required distributions before his annuity commences at age 85. In that case, the current rules would require Bill to pay required minimum distributions based on the value of the annuity, but he might not be in a position to access that value to make a required distribution. His retirement account assets that generated that value would have been paid to the insurance company and might not yet be available. To avoid this dilemma, longevity annuities generally tend not to be offered in 401(k) plans or IRAs.

The solution: Today's proposed regulations would help open up the 401(k) and IRA market to longevity annuities by giving special relief from the minimum distribution requirements. Under the proposal, an annuity that costs no more than 25 percent of the account balance or (if less) $100,000 and that will begin by age 85 is disregarded in determining required minimum distributions before the annuity begins.

The longevity annuity would have to satisfy certain limits on cash-out options and death benefits in order to ensure that it is used only to protect against longevity risk (the risk of outliving one's assets) and to make it as cost-effective as possible, leaving more in the individual's account to live on before the annuity begins. The proposed regulations also would require individuals to be given full and clear disclosure of the terms of the annuity.

Retirees who use a portion of their retirement savings to purchase a longevity annuity would enjoy the security of knowing that they will have lifetime income from the annuity even if they live well beyond their life expectancy.

> **Example (continued)**: Bill decides to use $30,000 from his $200,000 401(k) account to buy a longevity annuity available under the plan that begins at age 85 and continues making regular payments of about $17,000 per year as long as he lives.

Today's proposed regulations would make it practical for plans to offer the longevity annuity option because the value of the annuity would no longer count in determining required minimum distributions. Accordingly, Bill will satisfy the minimum distribution requirements from age 70 to age 85 from the remaining balance in his 401(k) account and will not be forced to start the annuity early as a result of those requirements. Beginning at age 85, Bill will rely on the lifetime income from the longevity annuity in addition to Social Security, any remaining amounts in the 401(k) account, and any additional resources he might have.

3. **Clarifying how 401(k) participants can be offered the option of purchasing an annuity from their employer's defined benefit plan**

Although the number of employees covered by private-sector defined benefit pension plans has been declining, many employers still sponsor defined benefit plans in addition to their 401(k) plans. As an alternative to offering lifetime income options to employees within the 401(k) plan, an employer could offer them low-cost annuities under its defined benefit plan. (Only a few employers currently do so.)

The regulatory barrier. An employer that wishes to offer this beneficial option to its employees is faced with uncertainty as to whether it is permissible and what rules apply.

The solution. A Treasury/IRS ruling issued today makes clear how this annuity purchase can be done under the qualified plan rules if the employer is interested in offering it.

For an employer that sponsors both a 401(k) (or other defined contribution plan) and a defined benefit plan, the ruling provides a road map for offering employees the option of transferring (or "rolling over") some or all of their 401(k) plan payouts to the defined benefit plan in exchange for an immediate annuity from that plan. The ruling makes clear that the defined benefit plan must convert the single-sum rollover amount to an annuity in a manner that is fair to the employee (i.e., the annuity must be at least "actuarially equivalent" to the amount the plan received, based on specified actuarial assumptions). These are the same assumptions that are used to convert annuity benefits to lump sums.

Defined benefit plans that can accept a rollover of a lump-sum payment from a 401(k) or other defined contribution plan and provide an annuity include both traditional and hybrid (such as cash balance) plans.

4. Clarifying how 401(k) participants can be offered the option of a deferred annuity under the 401(k) plan consistent with the plan qualification rules

The regulatory barrier: One factor that has made some 401(k) or other defined contribution plan sponsors hesitant to include lifetime income options in their plans has been uncertainty as to how certain plan qualification rules would apply to deferred annuities (including longevity annuities). The retirement plan rules require that an employee who elects certain optional forms of benefit obtain the written, notarized consent of the participant's spouse to that election. Questions have been raised as to how and when that requirement applies if an employee elects lifetime income that will begin in the future.

The solution: A Treasury/IRS ruling issued today makes it easier to offer deferred annuity options by resolving uncertainty as to how and when the spousal consent provisions apply with respect to pre-retirement and post-retirement survivor benefits. The ruling describes various arrangements permitting employees who are not yet ready to retire to invest their account balances in lifetime income benefits – either on a one-time basis or incrementally over a period of years – under deferred annuity contracts that will begin payments at retirement or later (including longevity annuities).

This guidance may be useful for plan sponsors that wish to offer annuity options under their plans but are reluctant to take responsibility for administering the spousal consent rules. The guidance identifies plan and annuity terms that will automatically protect spousal rights without requiring spousal consent before the annuity begins. At that time, the insurance company issuing the annuity would assure compliance with the spousal consent rules.