IRC Section 414(k) Accounts/Pension Portability

November 15, 2001

Carol Gold, Director
TE/GE Employee Plans Division
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224-0001

Re: IRC Section 414(k) Accounts/Pension Portability

Dear Ms. Gold:

The purpose of this letter is to emphasize the importance of IRC Section 414(k) accounts in promoting pension portability and to request that the Service reconsider the guidance, which has thus far been provided regarding such accounts.

ASPPA is a national organization of approximately 4,500 members who provide actuarial, consulting, administrative, legal and other professional services for about one-third of the qualified retirement plans in the United States, the majority of which are maintained by small businesses. ASPPA's mission is to educate pension actuaries, consultants, administrators and other benefits professionals and to preserve and enhance the private retirement system as part of the development of a cohesive and coherent national retirement income policy. Its large and broad-based membership gives it unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small employers.

Introduction

ASPPA wishes to commend the Service for a long history of promoting flexibility within the rules established by Congress. Code section 414(k), created by ERISA, allows a plan to have individual accounts within a defined benefit pension plan. In practice, we see these accounts providing participants, upon a distributable event and with proper spousal consent, the ability to transfer their benefit from the defined benefit plan and convert that benefit into a defined contribution account within the same plan. Administratively, this represents a cost savings (possibly quite significant) and reduction in operational burdens on plans and plan sponsors because they are not required to create or maintain a second plan to hold the distributed benefit.. With the potential for increases in stock portfolios, the conversion of defined benefit lump sums into individual accounts may give participants greater retirement savings. Another approach to the 414(k) feature is to provide, as a supplement to the defined benefit, a money purchase plan or after tax employee contribution accounts. These accounts grow with market value returns, and at retirement, the participant is allowed to convert these individual accounts into a monthly pension that provides a guaranteed benefit for the life of the participant and his or her spouse.

After ERISA, Congress has seen fit to allow rollovers with virtually any distributable event, for example direct rollovers created by UCA '92 and the provisions of EGTRRA permitting increased portability of benefits. The Service has even liberalized the rules for plans not covered by IRC Section 412 by allowing the plan sponsor to remove certain annuity forms of benefit if lump sums are available All of these factors suggest a strong policy in favor of benefit portability. Again, even though the accrued benefit could be rolled over to another plan or an IRA, administratively, it may be more efficient to simply convert the defined benefit into a defined contribution account (and benefit) within the same plan.

One seemingly discordant note in the overall theme of participants (and their spouses) gaining greater control and flexibility over their retirement benefits has been a Technical Advice Memorandum (TAM) issued in the mid-90's (TAM dated November 23, 1996 to Chief, EP/EO, Western Key District). Without ever mentioning IRC Section 414(k), the TAM takes the position that accounts set up under that section of the Code violate existing IRS regulations and, thus, are invalid. It is ASPPA's concern that, while there may have been deficiencies in the provisions of the lead document involved in the TAM that should not have been approved by the Service, defined benefit plans with provisions that properly reflect the Code and regulations should be permitted to have 414(k) accounts.

IRC Section 414(k)

IRC Section 414(k) reads,

(k) Certain Plans

A defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant shall--

> (1) for purposes of section 410 (relating to minimum participation standards), be treated as a defined contribution plan.
>
> (2) for purposes of sections 72(d) (relating to treatment of employee contributions as separate contract), 411(a)(7)(A) (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 401(m) (relating to nondiscrimination tests for matching requirements and employee contributions), be treated as consisting of a defined contribution plan to the extent benefits are based on the separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan, and
>
> (3) for purposes of section 4975 (relating to tax on prohibited transactions), be treated as a defined benefit plan.

The Service and the pension community have generally been in agreement with respect to how a Section 414(k) conversion works. With appropriate consent from the participant and spouse at a distributable event (usually attainment of normal retirement age), the actuarial value of the entire accrued benefit can be segregated into a separate account which, in the words of the Code, is "treated as a defined contribution plan", including for purposes of allocating investment gains and losses and for purposes of IRC Section 415. In addition, an individual account may be converted into a monthly pension using the plan's definition of actuarial equivalency.

The Service has not issued regulations under Section 414(k). Since there is little guidance, the pension community thought the Service's position was in agreement with common practice on how 414(k) accounts worked. As further evidence, the Service routinely approves prototype plans with the 414(k) conversion language as described above.

A final concurring piece of authority is that 414(k) DB/DC conversions were one of the issues litigated and resolved in the Actuarial Audit Cases before the Tax Court. Since the issues in these cases received extraordinary scrutiny from the Service, the pension community believed that 414(k) accounts were once more implicitly approved by the government. We presumed this ended any dispute, especially since the Tax Court made itself clear that it did not want to revisit issues it decided in those cases.

TAM Problem One – The Law

This leads us to the first problem with the TAM. It never mentions IRC Section 414(k). It never refers to it at all. We believe the absence of this reference is the TAM's fatal flaw. Without such a reference, the TAM completely fails to recognize the existence of Code Section 414(k) and how it might apply to a defined benefit plan.

Problem Number Two – The TAM Ruling Extended Beyond the Facts of the Case

The plan being examined in the TAM was the lead plan of a practitioner who was a volume submitter. The TAM states that "the amount of the Late Retirement Benefit is equal to the greater of the actuarial equivalent of the latest Adjusted Retirement Pension or the amount determined under the Plan's benefit formula taking into account increases (if any) in the participant's Benefit Service and Average Monthly Compensation subsequent to his (or her) Normal Retirement Date."

ASPPA believes the plan language on its face does not comply with the 414(k) conversion rules and, therefore, the ruling is correct to the extent it denies approval of this specific plan language. However, had plan-provided benefits accrued after a 414(k) conversion followed the same rules in which benefits accrue after a lump sum

distribution (namely without any further guarantee of the already provided benefit), then we believe the IRS should have ruled favorably. The TAM should have said that the proposed plan language did not comply with 414(k) and stopped.

TAM Problem Number Three – Misapplying Section 411(d)(6) and the Regulations

Code Section 411(d)(6) prohibits elimination of optional forms of benefits through plan amendments. ASPPA believes that the inclusion of 414(k) language in a plan offers the conversion to an individual account as an additional option within the plan, and is not an amendment that eliminates any other optional form.

In effect, the TAM incorrectly applies Code Section 411(d)(6) to operational choices under the plan and not as the statute intends, to plan amendments.

Further, the TAM says that the plan amendment which allows "the establishment of a Normal Retirement Account at normal retirement age ... is an amendment which eliminates the defined benefit feature of a participant's benefit under a defined benefit plan."

A plan amendment adding a 414(k) account feature that gives a participant who attains the Normal Retirement Age under the plan the option to create a DC account, with appropriate disclosure on the voluntary loss of defined benefit features, and with appropriate spousal consent, is not a plan amendment that eliminates the defined benefit feature of a participant's benefit. Rather it provides the participant with an option that he or she may elect in the disposition of this benefit.

Furthermore, the very 411(d)(6) regulations which the TAM uses as its only basis for rejecting an account which was intended to be a 414(k) account allows for elective transfers provided certain conditions are satisfied. Those conditions are:

The transfer is subject to the cash-out rules of section 411(a)(7), the early termination requirements of section 411 (d)(2), and the survivor annuity requirements of sections 401(a)(11) and 417.

The reason the TAM gives for saying that the DB/DC conversion does not enjoy the benefit of the elective transfer rules is that the benefits are not being moved to another plan but, rather, stay within the same plan. For that reason alone, says the TAM, the defined benefit feature cannot be waived even with proper participant and spousal consent.

The actual language of Code Section 414(k) refutes this position. Code Section 414(k) clearly anticipates two plans in operation, one is the defined benefit plan and the second is a defined contribution plan.

In addition, the reasoning of the TAM, that the DB/DC conversion does not enjoy the benefit of the elective transfer rules because the benefits are not being moved to another plan but, rather, stay within the same plan, is inconsistent and faulty. Almost all plans provide that a participant who elects a form of retirement benefit may not change the form once payments begin. All forms of benefit other than the one selected are therefore being eliminated at the election of the participant. Why is the "defined benefit feature" of the form of benefit different? Further, why is an election, which results in the current payment of benefits different from an election that does not result in the current payment of benefits? For example, the election of an "annuity certain" (*i.e.,* installments for a specified period of time) from a defined benefit pension plan also results in the elimination of the "defined benefit feature" without benefits being transferred to another plan. Because it is clear that an annuity certain is permissible, the TAM's basic argument cannot be supported.

We believe there is no policy reason to require distributions from a plan in order to allow a participant to convert the defined benefit feature of a benefit to a defined contribution feature. This same result can be obtained by having a lump sum distribution from the defined benefit plan into a defined contribution plan or IRA, and then rolling the proceeds back into the defined benefit plan.

Finally, ASPPA believes that the Service never intended the 411(d)(6) regulations to prohibit 414(k) conversions. It was six years after the regulations were issued that anyone suggested those regulations had any impact on 414 (k) accounts. In the meantime the Service has routinely approved prototype plans with the 414(k) conversion

language.

Conclusion

We believe there are various technical flaws in the TAM. There is also an overriding policy flaw in the TAM as discussed above. If the Commissioner wanted to create an exception to the general trend of Congress and the Service to allow increased flexibility and benefit portability for participants over the years, why would the Commissioner use only a TAM to reverse a long standing position of the Service allowing the use of 414(k) conversions?

ASPPA believes that neither the Commissioner, the IRS, nor Congress has any policy concerns with 414(k) conversions. The only problem is an aberrant TAM which did not rule on the facts before it, did not examine the law pertaining to the main issue (namely IRC Section 414(k)), and misapplied the rules of Code Section 411(d)(6) and the regulations under such law.

ASPPA requests the Service clarify its position with respect to 414(k) accounts and affirm that Code Section 414 (k) allows a participant in a defined benefit plan, upon a distributable event and with proper spousal consent, the ability to convert his or her defined benefit into a defined contribution account within the defined benefit plan.

These comments were prepared principally by Kurt Piper, Chair of the ASPPA Actuarial/PBGC subcommittee.

Sincerely,

Kurt F. Piper, MSPA, Chair
Actuarial/PBGC subcommittee

Brian Graff, Esq.
Executive Director

Bruce Ashton, APM, Esq., Co-Chair
Government Affairs Committee

R. Bradford Huss, APM, Esq. Co-Chair
Government Affairs Committee

Theresa Lensander, CPC, QPA, Chair
Administration Relations Committee