

## THE NEXT BIG DEBATE: 401(k) ANNUITIZATION

Should 401(k) plans be required to offer annuities? Clearly, an annuity option is not required under current law. Nevertheless, there are signs that this will become a significant issue in the very near future. A number of think tanks have suggested that annuitization of private pensions may be a partial solution to the impending Social Security crisis. Additionally, several insurers have been aggressively marketing a strategy that encourages in-service withdrawals from Section 401(k) plans to fund IRA's for purchase of annuity products.

There is very little information available regarding the extent to which retirees choose to annuitize their retirement benefits. Participants in Section 403(b) plans appear to be far more likely to annuitize than participants in 401(k) plans. However, even among 403(b) participants, the number of participants selecting a life annuity has declined as alternative distribution options have been expanded. According to the Employee Benefits Research Institute (EBRI), individuals electing an annuity made up the smallest group of those electing a rollover, at 7.2 percent. However, the percentage choosing an annuity did increase with age, reaching 18.2 percent for those ages 65 or older. Annuity use by date of the most recent distributions has remained essentially unchanged for those distributions taken from 1980 or after, at about 7 percent.<sup>1</sup>

The lack of annuitization among 401(k) participants should not be surprising. It has been reported that more than 70% of defined contribution plans do not offer a life annuity option to participants.<sup>2</sup>

---

<sup>1</sup> "Retirement Plan Participation and Retirees' Perception of Their Standard of Living." By Craig Copeland, EBRI. EBRI Issue Brief No. 269. January 2006.

<sup>2</sup> "Longevity-Insured Retirement Distributions from Pension Plans: Market and Regulatory Issues." By Jeffrey R. Brown and Mark J. Warshawsky. Prepared for the Brookings/SIEPR/TIAA-CREF Institute Conference on Public Policies and Private Pensions. September 21-22, 2000.

The push to encourage annuitization of retirement plans is coming from several sources. The shift from defined benefit pension plans to defined contribution plans is likely to reduce annuitization rates among future retirees. This will increase the exposure of many retirees to the risk of out-living retirement benefits. If individuals fail to adequately provide for old-age consumption needs, this could increase the financial pressure on means-tested social assistance programs such as Social Security Income and Medicaid.

Additionally, there is strong evidence that the failure to annuitize has an adverse impact on a retiree's standard of living. EBRI reports that a significant number of those who take lump sum distributions use at least some portion of the distribution for consumption. Those who took a lump sum distribution and spent it entirely were approximately 50% more likely to describe their standard of living as being somewhat or much worse than was reported by all of those age 55 or older who rolled over their assets.<sup>3</sup>

On May 6, 2006, Americans for Secure Retirement (ASR)<sup>4</sup> released a poll showing that more working Americans aged 50-70 years old (50%) are concerned about making their retirement savings last their lifetime than are concerned with saving enough for retirement (38%). The poll -- jointly conducted by Republican pollster Bill McInturff of Public Opinion Strategies and Democratic pollster Mark Mellman of the Mellman Group -- also found that more than two-thirds of older American voters are concerned about maintaining their living standard throughout

---

<sup>3</sup> *Ibid.*

<sup>4</sup> Americans for Secure Retirement was formed by the Committee of Annuity Insurers, and the American Council of Life Insurers (ACLI) to form a coalition to pursue enactment of legislation that would provide a tax incentive for life-contingent annuities.

retirement, and nearly half (48%) say they are more concerned about this than when they first retired.

There is currently pending in Congress legislation that would provide tax incentives to invest in individual annuity contracts. H.R. 819 would allow an exclusion from gross income for 50 percent (up to \$20,000) of the amount otherwise includible in gross income as guaranteed payments from certain annuity or life insurance contracts. Although this legislation does not directly impact qualified retirement plans, its enactment would discourage 401(k) deferrals in favor of investment in an individual annuity contract.

Other recommendations for encouraging annuitization of retirement benefits will have a direct impact on plans and their sponsors. These include the following:

- Mandate that every tax-qualified employer-sponsored retirement plan provided any benefits payable to a participant below a certain dollar level be paid entirely and life annuity form.
- Mandate that employers make annuitization the default distribution option in all defined contribution plans.
- Provide tax credit incentives to plan sponsors to offer annuities through their plans. These incentives would be to cover the plan's increased administrative cost of offering the annuity option.
- Provide tax incentives to qualified plan participants to elect annuity payments, similar to the incentives offered in H.R. 819.

Plan sponsors and their advisors will want to watch the annuitization discussion closely and weigh in with their own opinions and concerns.

Reprinted with permission from Aspen Publishers' July 2007 401(k) Advisor. Contact Aspen at 1-800-638-8437.