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Removing the Legal Impediments to Offering Lifetime Annuities in Pension Plans*

Jonathan Barry Forman†

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Longevity risk—the risk of outliving one’s retirement savings—is probably the greatest risk facing current and future retirees in the United States. At present, for example, a 65-year-old man has a 50 percent chance of living to age 82 and a 20 percent chance of living to age 89, and a 65-year-old woman has a 50 percent chance of living to age 85 and a 20 percent chance of living to age 92. The joint life expectancy of a 65-year-old couple is even more remarkable: there is a 50 percent chance that at least one 65-year-old spouse will live to age 88 and a 30 percent chance that at least one will live to 92. In short, many individuals and couples will need to plan for the possibility of retirements that can last for 30 years or more. There were 48.6 million retirees in the United States in 2014, but there are expected to be 66.4 million retirees in 2025 and 82.1 million in 2040.

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†Alfred P. Murrah Professor of Law, University of Oklahoma; B.A. 1973, Northwestern University; M.A. (Psychology) 1975, University of Iowa; J.D. 1978, University of Michigan; M.A. (Economics) 1983, George Washington University.
One of the best ways to protect against longevity risk is by securing a stream of lifetime income with a traditional defined benefit pension plan or a lifetime annuity. Over the years, however, there has been a decided shift away from traditional pensions and towards 401(k) plans and other defined contribution plans that typically distribute benefits in the form of lump sum distributions rather than as lifetime annuities. When given the choice, people rarely choose to receive annuity distributions, nor is it common for people to buy annuities in the retail annuity market. All in all, Americans will have longer and longer retirements, yet fewer and fewer retirees will have secure, lifetime income streams.

This Article considers how changes in the laws and regulations governing pensions and annuities could help promote secure, lifetime income streams. More specifically, this Article explores how the laws governing annuities could be changed to make voluntary annuitization more attractive and how pension laws could be changed to incentivize plan sponsors to offer more lifetime income options and to encourage plan participants to select those options.

After a brief introduction, Part II of this Article provides an overview of Social Security, pensions, annuities, and other lifetime income mechanisms in the United States. Next, Part III focuses on the legal rules that govern annuities and pension distributions, and Part IV discusses the role for pensions, annuities, and other lifetime income mechanisms in providing secure, lifetime income streams. Finally, Part V considers some options for statutory and regulatory changes that would promote greater annuitization of retirement savings.

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I. INTRODUCTION

Longevity risk—the risk of outliving one’s retirement savings—is probably the greatest risk facing current and future retirees in the United States. At present, for example, a 65-year-old man has a 50 percent chance

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of living to age 82 and a 20 percent chance of living to age 89, and a 65-year-old woman has a 50 percent chance of living to age 85 and a 20 percent chance of living to age 92.\(^2\) The joint life expectancy of a 65-year-old couple is even more remarkable: there is a 50 percent chance that at least one 65-year-old spouse will live to age 88 and a 30 percent chance that at least one will live to 92.\(^3\) In short, many individuals and couples will need to plan for the possibility of retirements that can last for 30 years or more. There were 48.6 million retirees in the United States in 2014, but there are expected to be 66.4 million retirees in 2025 and 82.1 million in 2040.\(^4\)

One of the best ways to protect against longevity risk is by securing a stream of lifetime income with a traditional defined benefit pension plan\(^5\) or a lifetime annuity.\(^6\) Over the years however, there has been a decided shift in the way retirement income is being provided. This paper will explore why lifetime annuities are an option you need to consider as you plan your retirement.

\(^2\) Calculations from the Soc’y of Actuaries, Life Expectancy Calculator (last visited Aug. 2, 2016), https://www.soa.org/Files/Xls/research-life-expect-calc.xls (based on the Social Security Administration’s 2010 mortality tables for the general U.S. population; an individual’s life expectancy is the average number of years until death). See also AM. ACAD. OF ACTUARIES, Risky Business: Living Longer Without Income for Life 4–8 (Discussion Paper, June 2013), https://www.actuary.org/files/Risky-Business_Discussion-Paper_June_2013.pdf (showing the probability of living from age 65 to various ages and discussing various factors that can affect that probability); SOC. SEC. ADMIN., Retirement & Survivors Benefits: Life Expectancy Calculator (last visited Mar. 22, 2016), https://www.socialsecurity.gov/oact/population/longevity.html (a calculator that can be used to estimate individual and joint life expectancies).

\(^3\) Soc’y of Actuaries, Life Expectancy Calculator, supra note 2.


\(^5\) As more fully discussed in Part II.C.1.a, infra, in a defined benefit plan, an employer promises employees a specific “benefit” at retirement. For example, a traditional defined benefit plan might promise to pay a long-time employee a pension equal to 60 percent of her final pay for the rest of her life.

\(^6\) As more fully discussed in Part II.D.2, infra, an annuity is a financial instrument (i.e., an insurance contract) that converts a lump sum of money into a stream of income payable over a period of years, typically for life. See, e.g., U.S. SEC. AND EXCH. COMM’N, Annuities, http://www.sec.gov/answers/annuity.htm (last updated Apr. 6, 2011); Annuities, INVESTOR.GOV, U.S. SEC. AND EXCH. COMM’N, http://m.investor.gov/investing-basics/investment-products/annuities (last visited
away from traditional pensions and towards 401(k) plans and other defined contribution plans that typically distribute benefits in the form of lump sum distributions rather than as lifetime annuities. When given the choice, people rarely choose to receive annuity distributions, nor is it common for people to buy annuities in the retail annuity market. All in all, Americans will have longer and longer retirements, yet fewer and fewer retirees will have secure, lifetime income streams.

This Article considers how changes in the laws and regulations governing pensions and annuities could help promote secure, lifetime income streams. More specifically, this Article explores how the laws governing annuities could be changed to make voluntary annuitization more attractive and how pension laws could be changed to incentivize plan sponsors to offer more lifetime income options and to encourage plan participants to select those options.

Part II of this Article provides an overview of Social Security, pensions, annuities, and other lifetime income mechanisms in the United States. Next, Part III focuses on the legal rules that govern annuities and pension distributions, and Part IV discusses the role for pension, annuities, and other lifetime income mechanisms in providing secure, lifetime income streams. Finally, Part V considers some options for statutory and regulatory changes that would promote greater annuitization of retirement savings.


7 As more fully discussed in Part II.C.1.b, infra, 401(k) plans are retirement savings plans that are authorized by I.R.C. § 401(k) (2014).

8 As more fully discussed in Part II.C.1.b, infra, in a defined contribution plan, the plan sponsor promises to make a specific “contribution” into an individual investment account for each employee. For example, an employer might contribute 10 percent of annual compensation each year to each employee’s account, and, at retirement, each employee would be entitled to a benefit based on all those contributions plus investment earnings.

9 Id.

10 Id.

11 See infra Parts II.D.2 & IV.A.
II. AN OVERVIEW OF SOCIAL SECURITY, PENSIONS, AND OTHER LIFETIME INCOME MECHANISMS IN THE UNITED STATES

Elderly Americans can generally count on Social Security benefits to cover at least a portion of their retirement income needs. In addition, retirees use pensions, annuities, and a variety of other mechanisms to ensure that they have adequate incomes throughout their retirement years. These are discussed in turn.

A. SOCIAL SECURITY

Social Security provides monthly cash benefits to retirees and their families.12 A worker builds Social Security protection by working in employment that is covered by Social Security and paying the applicable payroll taxes. At retirement, disability, or death, monthly benefits are paid to insured workers and to their eligible dependents and survivors. While “full retirement age” was once age 65, it is currently age 66, and it is gradually increasing to age 67 for workers born after 1959 (who reach age 67 in or after 2027).13 In January of 2016, Social Security paid retirement benefits to more than 40.2 million retired workers, and the average monthly benefit paid to a retired worker was $1343.68.14

Social Security retirement benefits are financed primarily through payroll taxes imposed on individuals working in employment or self-employment that is covered by the Social Security system.15 Workers over the age of 62 generally are entitled to Social Security retirement benefits if

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they have worked in covered employment for at least 10 years. Benefits are based on a measure of the worker’s earnings history in covered employment. The benefit formula is highly progressive, and, as a result, the Social Security retirement system favors workers with low lifetime earnings relative to workers with higher lifetime earnings. These redistributive Social Security retirement benefits play an important role in reducing poverty among the elderly. Roughly two-thirds of aged Social Security beneficiaries receive at least half of their income from Social Security.

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18 Benefits for retired workers are based on a measure of the worker’s earnings history in covered employment known as the “average indexed monthly earnings” (AIME). Id. The starting point for determining the worker’s AIME is to determine how much the worker earned each year through age 60. Once those “benefit computation years” and “covered earnings” for those years have been identified, the worker’s earnings are indexed for wage inflation, using the year the worker turns 60 to index the earnings of prior years. The highest 35 years of earnings are then selected, and the other years are dropped out. The AIME is then computed as the average earnings for the remaining 35 years (420 months). The AIME is then linked by a progressive formula to the monthly retirement benefit payable to the worker at full retirement age, a benefit known as the “primary insurance amount” (PIA). For a worker turning 62 in 2016, the PIA equals 90 percent of the first $856 of the worker’s AIME, plus 32 percent of the AIME over $856 and through $5,157 (if any), plus 15 percent of the AIME over $5,157 (if any). Id.; SOC. SEC. ADMIN., Primary Insurance Amount, http://www.ssa.gov/oact/cola/piaformula.html (last visited July 19, 2016).
Benefits may be increased or decreased for several reasons. Most importantly, benefits are indexed each year for inflation as measured by the consumer price index.\textsuperscript{22} Also, the “retirement earnings test” can reduce the monthly benefits of individuals who have not yet reached full retirement age but who continue to work after starting to draw Social Security retirement benefits.\textsuperscript{23}

In addition, workers who retire before their full retirement age have their benefits actuarially reduced.\textsuperscript{24} On the other hand, benefits payable to workers who choose to retire after their full retirement age are actuarially increased (but only up to age 70).\textsuperscript{25} In effect, beneficiaries can buy additional annuity protection by delaying retirement.\textsuperscript{26} For example, consider a worker who reached age 62 in January 2016 and earned the maximum taxable amount under Social Security for every year of her working life. If she claimed her Social Security benefits at 62, she would get a starting benefit of $2102 per month, but if she instead waited until she is 65 to start drawing her benefits, she would get $2491 per month, and if she waited until age 70, she would get $3576 per month—and she could get even more when cost-of-living increases and extra earnings are factored in.\textsuperscript{27}

In addition to Social Security benefits, a means-tested Supplemental Security Income (SSI) program provides monthly cash benefits to certain low-income elderly, disabled, or blind Americans.\textsuperscript{28} In 2016, the maximum federal benefit for a single individual is $733 per month, and the maximum

\begin{itemize}
  \item \textsuperscript{22} See, e.g., SOC. SEC. ADMIN., 2017 Social Security Changes, supra note 15.
  \item \textsuperscript{23} 42 U.S.C. § 403(f) (2000).
  \item \textsuperscript{24} 42 U.S.C. § 402(q) (2015).
  \item \textsuperscript{25} 42 U.S.C. § 402(w) (2015).
  \item \textsuperscript{27} SOC. SEC. ADMIN., Workers with Maximum-Taxable Earnings, http://www.ssa.gov/oact/cola/examplemax.html (last visited July 19, 2016).
  \item \textsuperscript{28} See, e.g., HOUSE WAYS AND MEANS COMMITTEE, GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS, supra note 12, at Chapter 3: Supplemental Security Income.
\end{itemize}
for a couple is $1,100 per month.\textsuperscript{29} In January of 2016, almost 2.2 million elderly Americans received SSI benefits from the federal government, and the average monthly benefit was $434.68.\textsuperscript{30}

B. \textbf{A BRIEF OVERVIEW OF RETIREMENT SAVINGS}

Before delving into the details of pensions, annuities, and other ways of providing lifetime retirement income, it is worth taking a brief look at the magnitude and nature of household retirement savings. According to the Federal Reserve Board, Americans had $27.3 trillion in household retirement assets at the end of 2015, including $11.3 trillion in defined benefit plans, $6.3 trillion in defined contribution plans, $7.4 trillion in individual retirement accounts (IRAs), and $2.3 trillion in annuities.\textsuperscript{31} While Americans can also use their other financial assets, and even their houses,\textsuperscript{32} to help provide them with retirement income, the primary focus of this Article is on the household retirement saving items identified by the Federal Reserve Board. Of the $8.5 trillion in private-sector pension plans, $3.1 trillion was held by defined benefit plans, and $5.4 trillion was held by defined contribution plans.\textsuperscript{33} On the other hand, of the $5.6 trillion in state and local pension plans, $5.2 trillion was held by defined benefit plans, and just $478 billion was held by defined contribution plans.\textsuperscript{34} Similarly, of the $3.8 trillion

\begin{itemize}
\item \textsuperscript{29} \textsc{soc. sec. admin.}, \textit{SSI Federal Payments for 2016}, http://www.ssa.gov/oact/cola/SSI.html (last visited July 19, 2016).
\item \textsuperscript{30} \textsc{soc. sec. admin.}, \textit{Monthly Statistical Snapshot, January 2016}, supra note 14, at 3 tbl.3.
\item \textsuperscript{31} \textsc{bd. of governors of the fed. reserve sys.}, \textit{financial accounts of the united states: flow of funds, balance sheets, and integrated macroeconomic accounts: fourth quarter 2015} (Mar. 10, 2016), http://www.federalreserve.gov/releases/z1/current/z1.pdf, at tbl.L.117. \textit{See also inv. co. inst.}, \textit{quarterly retirement market data}, https://www.ici.org/research/stats/retirement (last visited July 19, 2016) (providing data on retirement savings assets in the United States for the most recent quarter). For a discussion of IRAs, see Part II.C.1.d, infra.
\item \textsuperscript{32} \textit{See, e.g.}, \textsc{U.S. dep’t of hous. & urban dev.}, \textit{Frequently Asked Questions About HUD’s Reverse Mortgages}, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/rtopten (last visited July 19, 2016).
\item \textsuperscript{33} \textsc{bd. of governors of the fed. reserve sys.}, \textit{financial accounts of the united states: flow of funds, balance sheets, and integrated macroeconomic accounts: fourth quarter 2015}, \textit{supra} note 31, at tbls.L.118, L.118.b & L.118.c.
\item \textsuperscript{34} \textit{Id.} at tbls.L.120, L.120.b & L.120.c.
\end{itemize}
in federal government pension plans, $3.3 trillion was held in defined benefit plans, and just $430 billion was held in defined contribution plans.\(^{35}\)

C. PENSION PLANS

The United States has a “voluntary” private pension system, and employers can decide whether and how to provide pension benefits for their employees.\(^ {36}\) However, when employers do provide pensions, those pensions are typically subject to regulation under the Employee Retirement Income Security Act of 1974 (ERISA).\(^ {37}\) Overall, in March of 2016, 66 percent of private-sector workers had access to ERISA retirement plans, and 49 percent of them participated.\(^ {38}\)

To encourage Americans to save for retirement in our voluntary pension system, the government relies on two major approaches. First, most pension plans qualify for favorable tax treatment. Basically, employer contributions to a pension are not taxable to the employee;\(^ {39}\) the pension fund’s earnings on those contributions are tax-exempt;\(^ {40}\) and employees pay

\(^{35}\) Id. at tbls.L.119, L.119.b & L.119.c. A little bit of caution is warranted here, as the federal government includes both its funded and unfunded obligations to the plans as “assets” of the plans. For example, of the $3.8 trillion “held” by federal pensions, $1.7 trillion is identified as marketable and nonmarketable Treasury securities, and $1.8 trillion represent claims of the pension funds on the sponsor. Id. at tbl.L.119.


\(^{40}\) I.R.C. § 501(a) (2015). Most pensions hold assets in a trust. I.R.C. § 401(a) (2014); INTERNAL REVENUE SERV., A Guide to Common Qualified Plan Requirements, https://www.irs.gov/Retirement-Plans/A-Guide-to-Common-Qualified-Plan-Requirements (last updated June 6, 2016) (“A trust is a medium under which the retirement plan assets are accumulated. The employer or employees, or both, contribute to the trust, which forms part of the retirement plan. The assets
tax only when they receive distributions of their pension benefits.41 Nevertheless, the employer is allowed a current deduction for its contributions (within limits).42 Distributions from a pension plan may generally be rolled over tax-free to another pension plan or to an IRA.43 Second, employers and workers are given great flexibility in designing their pension plans, in making contributions, and in making (or taking) distributions.44

Despite these retirement savings incentives, pension coverage and participation rates are low. At any point in time, only about one out of two American workers have pension plans. For example, of the 157.3 million Americans workers in 2013, just 80.7 million (51.3 percent) worked for an employer (or union) that sponsored a retirement plan, and just 64.2 million (40.8 percent) participated in that plan.45 The probability of pension coverage are held in the trust until distributed to the employees or their beneficiaries according to the plan’s provisions.”). In passing, however, it should be noted that so-called “qualified annuity plans” are invested in annuity contracts rather than held in a trust. I.R.C. §§ 403(a) (2008), 404(a)(2) (2014); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, supra note 37, at 18.


is greater for older workers, for whites, for highly educated workers, for full-time workers, for higher-income workers, and for workers at larger firms. Participation in IRAs is even lower than participation in pensions. For example, while 32 percent of U.S. households had an IRA in 2015, only around 14 percent of households made contributions to their IRAs (in 2014).

1. Types of Pension Plans

Pension plans generally fall into two broad categories based on the nature of the benefits provided: defined benefit plans and defined contribution plans.

a. Defined Benefit Plans

In a defined benefit plan, an employer promises employees a specific benefit at retirement. For example, a plan might provide that a worker’s annual retirement benefit ($B$) is equal to 2 percent times the number of years of service ($yos$) times final average compensation ($fac$) ($B = 2\text{ percent} \times yos \times fac$). Under this traditional, final-average-pay formula, a worker who retires after 30 years of service with final average compensation of $50,000 would receive a pension of $30,000 a year for life ($30,000 = 2\text{ percent} \times 30 yos \times $50,000 fac$).
The default benefit for defined benefit plans is a retirement income stream in the form of an annuity for life. While many defined benefit plans allow for lump sum distributions, most retirees receive lifetime annuities. According to the U.S. Government Accountability Office, 67.8 percent of workers who left employment and retired with a defined benefit pension from 2000 through 2006 took the defined benefit plan annuity. For married participants, defined benefit plans (and some defined contribution plans) are required to provide a qualified joint-and-survivor annuity (QJSA) as the normal benefit payment, unless the spouse consents to another form of distribution. Defined benefit plans generally cannot make in-service distributions to a participant before age 62, but they may permit loans to participants.

b. Defined Contribution Plans


50 In the United States, defined benefit plans are generally designed to provide annuities, i.e., “definitely determinable benefits . . . over a period of years, usually for life after retirement.” Treas. Reg. § 1.401-1(b)(1) (2016).


contributes to an individual investment account for the worker. For example, contributions might be set at 10 percent of annual compensation. Under such a plan, a worker who earned $50,000 in a given year would have $5,000 contributed to an individual investment account for her ($5,000 = 10 percent × $50,000). Her benefit at retirement would be based on all such contributions plus investment earnings. Many defined contribution plans also provide for loans to participants, and some plans can also provide in-service “hardship” distributions. Unlike defined benefit plans, defined contribution plans usually make distributions as lump sum or periodic distributions rather than as lifetime annuities. Indeed, relatively few defined contribution plans even offer annuity options, and, in any event, relatively few participants elect

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54 STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, supra note 37, at 10.

55 Defined contribution plans are also known as “individual account” plans because each worker has her own account, as opposed to defined benefit plans, where the plan’s assets are pooled for the benefit of all of the employees. ERISA § 3(34), 29 U.S.C. § 1002(34) (2008).


57 See, e.g., STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, supra note 37, at 31–33.

those annuity options. There are exceptions like TIAA—which reports that around 75 percent of its beneficiaries receive annuity payments. Also, some


In the United States, there are a variety of different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock annuitized a portion of their retirement savings); Beverly I. Orth, Approaches for Promoting Voluntary Annuitization, in 2008 Retirement 20/20 Conference (Society of Actuaries Monograph No. M-RS08-1, 2009), http://www.soa.org/library/monographs/retirement-systems/retirement2020/2008/november/mono-2008-m-rs08-01-orth.pdf; Michael Hurd & Constantijn Panis, The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement, 90(12) J. OF PUB. ECON. 2213 (2006) (finding that just 7 percent of workers who retired from a job with a defined contribution plan converted their retirement savings into an annuity).

\footnote{See, e.g., Diane Oakley & Jennifer Erin Brown, Preserving Retirement Income Security for Public Sector Employees 14, NAT’L INST. ON RET. SEC. (July 2016), http://www.nirsonline.org/storage/nirs/documents/Portability%20Report/preserving_security_public_sector_web.pdf (noting that the Colorado Public Employees’ Retirement Association allows retirees to convert their defined contribution account balances into annuities “at the PERA assumed rate of return, which is less costly than purchasing an annuity from an insurance company”).}
ownership plans ("ESOPs"). Of particular importance, profit-sharing and stock bonus plans often include a feature that allows workers to choose between receiving cash currently or deferring taxation by placing the money in a retirement account according to Internal Revenue Code Section 401(k). Consequently, these plans are usually called "401(k) plans," and they are the most popular type of retirement plan in the United States. The maximum annual amount of such elective deferrals that can be made by an individual in 2017 is $18,000, although workers over the age of 50 can contribute another $6,000 (for a total of up to $24,000). Also, since 2006, employers have been permitted to set up Roth 401(k) plans.

Section 401(k) plans may be designed so that the employee automatically makes elective deferrals at a specified rate unless the employee elects otherwise. Such automatic enrollment features can lead to higher participation rates, and automatically escalating the participants’ levels of contributions can lead to even greater retirement savings.

In passing, it should be noted that 401(k)-type rules also

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65 I.R.C. § 402A (2014). Contributions to these plans are not excludable, but neither the plan’s investment returns nor distributions are taxable.


apply to so-called “403(b) plans” that are used by many tax-exempt organizations and public schools (including colleges and universities). 68

c. **Hybrid Retirement Plans**

So-called “hybrid” retirement plans mix the features of defined benefit and defined contribution plans. For example, a cash balance plan is a defined benefit plan that looks like a defined contribution plan. 69

d. **Individual Retirement Accounts**

Favorable tax rules are also available for individual retirement accounts (IRAs). 70 Almost any worker can set up an IRA with a bank or other financial institution. In 2017, individuals without pension plans can contribute and deduct up to $5,500 to an IRA, although individuals over age 50 can contribute and deduct another $1,000 (for a total of up to $6,500); and

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68 I.R.C § 403(b) (2008); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-Favored RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, supra note 37, at 18–21 (also discussing so-called “457(b) plans” used by State and local government and tax-exempt employers).

69 See, e.g., Jonathan Barry Forman & Amy Nixon, Cash Balance Pension Plan Conversions, 25(1&2) OKLA. CITY U. L. REV. 379 (2000). Like other defined benefit plans, employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. Like defined contribution plans, however, cash balance plans provide workers with individual accounts (albeit hypothetical). A simple cash balance plan might allocate 10 percent of salary to each worker’s account each year and credit the account with 5 percent interest on the balance in the account. Under such a plan, a worker who earned $50,000 in a given year would get an annual cash balance credit of $5,000 ($5,000 = 10 percent × $50,000), plus an interest credit equal to 5 percent of the balance in her hypothetical account as of the beginning of the year.

spouses can contribute and deduct similar amounts.71 If a worker is covered by another retirement plan, however, the deduction may be reduced or eliminated in 2017 if the worker’s income exceeds $62,000 for a single individual or $99,000 for a married couple.72 Like private pensions, IRA earnings are tax-exempt, and distributions are taxable.73

Also, since 1998, individuals have been permitted to set up Roth IRAs.74 Unlike regular IRAs, contributions to Roth IRAs are not deductible. Instead, withdrawals are tax-free.75 Like regular IRAs, however, Roth IRA earnings are tax-exempt.76

These days, rollovers from pension plans account for most of the balances in IRAs. For example, according to one recent study, 14.5 times as many dollars added to IRAs in 2013 came from rollovers than came from contributions.77 Another recent study found that the majority (62 percent) of recent retirees with at least $75,000 in a defined contribution plan at retirement moved their assets out of those plans, and the overwhelming majority of them rolled their money into an IRA.78

71 INTERNAL REVENUE SERV., IRS Announces 2017 Pension Plan Limitations; 401(k) Contribution Limit Remains Unchanged at $18,000 for 2017, supra note 64.
72 Id.
74 I.R.C. § 408A (2010).
75 STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, supra note 37, at 38–39.
76 Id.
As more fully discussed in Part III.D below, individuals can use their IRAs to buy annuities, although data limitations make it hard to get an accurate estimate of how often that happens.  

e. Other Tax Benefits for Retirement Savings

Also, since 2002, certain low- and moderate-income individuals have been able to claim a saver’s tax credit of up to $1000 for certain qualified retirement savings contributions. Finally, qualified small firms may claim a nonrefundable tax credit of up to $500 for certain costs incurred in setting up a new retirement plan for employees (“start-up credit”).

2. The Regulation of Employment-based Plans

Since it was enacted more than 40 years ago, the Employee Retirement Income Security Act (ERISA) has been amended numerous times, and a whole regulatory system has grown up to enforce its provisions. The key agencies charged with the administration of ERISA are the U.S. Department of Labor, the Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC).

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80 I.R.C. § 25B (2013); INTERNAL REVENUE SERV., Retirement Savings Contributions Credit (Saver’s Credit), https://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Savings-Contributions-Savers-Credit (last updated Feb. 22, 2016). The credit equals a percentage (50 percent, 20 percent, or 10 percent) of up to $2,000 of contributions. In effect, the credit acts like an employer match: the government matches a portion of the employee’s contributions. Employer matches encourage workers to contribute, at least up to the match level, and the saver’s tax credit seems to have similar pro-savings effects. See, e.g., Lisa Southwirth & John Gist, The Saver’s Credit: What Does It Do For Saving?, AARP POL’Y INST. (Insight on the Issues Paper, 2008), http://assets.aarp.org/rgcenter/econ/i1_credit.pdf.
81 I.R.C. § 45E (2002); INTERNAL REVENUE SERV., Retirement Plans Startup Costs Tax Credit, https://www.irs.gov/Retirement-Plans/Retirement-Plans-Startup-Costs-Tax-Credit (last updated Aug. 18, 2015). The credit is equal to 50 percent of up to $1,000 in eligible costs incurred in each of the first three years of the plan’s existence.
Pension plans must be operated for the exclusive benefit of employees (and beneficiaries). To protect the interests of plan participants, ERISA requires significant reporting and disclosure in the administration and operation of employee benefit plans. ERISA also imposes extensive fiduciary responsibilities on plan sponsors and the administrators of employee benefit plans.

In general, a fiduciary includes any person who: (1) exercises any authority or control respecting management or disposition of the plan’s assets; (2) renders investment advice for a fee or other compensation with respect to any plan money or property, or has the authority or responsibility to do so; or (3) has any discretionary authority or responsibility in the administration of the plan. When acting as a fiduciary, the plan sponsor must:

1. operate solely in the best interest of the participants and beneficiaries and with the exclusive purpose of providing benefits to them;
2. carry out its duties prudently;
3. follow the plan documents (unless inconsistent with ERISA); and
4. diversify the plan’s investments; and pay only reasonable plan expenses.


The fiduciary duty under ERISA is the “highest duty known to the law,” and fiduciary “decisions must be made with an eye single to the interests of the participants and beneficiaries.”

Of note, the U.S. Department of Labor recently extended the definition of a fiduciary to virtually all retirement advisers who receive compensation for providing investment advice to plan sponsors, plan participants, or IRA owners. The new fiduciary conflict-of-interest rule will apply to those who sell annuities to pension plans and IRAs.

In addition to the fiduciary responsibility rules, so-called “prohibited transaction” rules prevent parties in interest from engaging in certain transactions with the plan. ERISA and the Internal Revenue Code impose many other requirements on retirement plans, including rules governing participation, coverage, vesting, benefit accrual, contribution and

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89 Id. at 680 F.2d at 271.
In addition to meeting their funding obligations, defined benefit plans in the private sector must also pay premiums to the PBGC for plan termination insurance. In the event that an underfunded, private-sector plan becomes underfunded, the funding rules generally require them to make up that shortfall by making level installment payments amortized over seven years. As ERISA does not apply to governmental plans, however, many such plans are underfunded.

Distributions after the death of a plan participant must also meet certain minimum distribution requirements. An exception allows older workers with a pension plan from their current employer to delay distributions until they retire, but workers with pensions from prior employers and IRA holders must begin taking distributions from those plans soon after they reach age 70½. Failure to take the required minimum distribution can result in a 50 percent excise tax penalty on the excess of the amount required to have been distributed over the amount that actually was distributed. I.R.C. § 4974 (2007). In addition, a plan that fails to make the required minimum distributions can be disqualified. INTERNAL REVENUE SERV., Fixing Common Plan Mistakes - Failure to Timely Start Minimum Distributions, https://www.irs.gov/retirement-plans/plan-sponsor/fixing-common-plan-mistakes-failure-to-timely-start-minimum-distributions (last updated Jan. 22, 2016).

ERISA § 4006, 29 U.S.C. § 1306 (2012); PENSION BENEFIT GUAR. CORP., Premium Rates,

100 I.R.C. § 72(t) (2012); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-Favored Retirement Saving and Certain Related Legislative Proposals, supra note 37, at 43.
101 I.R.C. § 401(a)(9) (2011); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-Favored Retirement Saving and Certain Related Legislative Proposals, supra note 37, at 43–47. More specifically, distributions typically must begin no later than April 1 of the calendar year following the calendar year in which the employee attains age 70½. Distributions after the death of a plan participant must also meet certain minimum distribution requirements. An exception allows older workers with a pension plan from their current employer to delay distributions until they retire, but workers with pensions from prior employers and IRA holders must begin taking distributions from those plans soon after they reach age 70½. I.R.C. § 401(a)(9) (2011). Failure to take the required minimum distribution can result in a 50 percent excise tax penalty on the excess of the amount required to have been distributed over the amount that actually was distributed. I.R.C. § 4974 (2007). In addition, a plan that fails to make the required minimum distributions can be disqualified. INTERNAL REVENUE SERV., Fixing Common Plan Mistakes - Failure to Timely Start Minimum Distributions, https://www.irs.gov/retirement-plans/plan-sponsor/fixing-common-plan-mistakes-failure-to-timely-start-minimum-distributions (last updated Jan. 22, 2016).

ERISA § 4006, 29 U.S.C. § 1306 (2012); PENSION BENEFIT GUAR. CORP., Premium Rates,
defined benefit plan terminates (for example, because the employer goes out of business), the PBGC will pay annual pension benefits of up to $64,432 per participant in 2017 ($5,369.32 per month). The PBGC insures the benefits of more than 40 million workers and retirees, and it pays benefits to nearly 840,000 people each month.

Federal laws outside of ERISA and the Internal Revenue Code can also impose limits on pension plans. For example, even though women tend to live longer than men, Title VII of the Civil Rights Act of 1964 bars pension plans from requiring higher contributions from women than men or paying women lower benefits than men.

3. The Shift from Defined Benefit Plans to Defined Contribution Plans

Over the past few decades, there has been a major shift from traditional defined benefit plans to defined contribution plans. As already


105 See, e.g., supra note 2 and accompanying text.


107 See, e.g., STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, supra note 37, at 56, 57 fig.2. See also William J. Wiatrowski, CHANGING LANDSCAPE OF EMPLOYMENT-BASED RETIREMENT BENEFITS, COMP. AND WORKING CONDITIONS ONLINE (U.S. Dep't of Labor, Bureau of Labor Statistics, Sept. 29, 2011), http://www.bls.gov/opub/mlr/cwc/changing-
mentioned, 66 percent of private-sector workers had access to ERISA retirement plans in 2016, and 49 percent of them participated, but defined contribution plans have come to dominate the pension landscape. For example, just 20 percent of Fortune 500 companies offered salaried employees a defined benefit plan in 2015, down from 59 percent in 1998. According to the most recent complete data from the U.S. Department of Labor, there were 681,000 ERISA-covered private pension plans in the United States in 2013. Of these ERISA-covered plans, just 44,163 were defined benefit plans, and these defined benefit plans had a total of $2.9 trillion in assets. These defined benefit plans had 39.1 million participants but just 15.2 million of those were active participants (i.e., current employees as opposed to retirees and other separated participants).

On the other hand, there were 636,991 defined contribution plans in 2013, and these had a total of $5.0 trillion in assets. These defined contribution plans had 92.5 million participants, including 76.7 million active participants. Of these defined contribution plans, 527,000 were 401(k)-type plans.

As more fully explained in Part III.E below, the current movement away from defined benefit plans in the private sector is known as “de-risking.” All in all, the era of the traditional defined benefit plan in the private sector is largely behind us.

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108 See supra note 38 and accompanying text.
109 See, e.g., STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, supra note 37, at 54–57.
112 Id. at 3 tbl.A1.
113 Id.
114 Id.
115 Id.
116 Id. at 1, 2.
There has also been a shift from defined benefit plans to defined contribution plans in the public sector. For example, in 1986, the federal government replaced much of its traditional defined benefit plan for civilian employees with the “Thrift Savings” defined contribution plan. The shift from defined benefit to defined contribution plans among state and local governments has been more modest.

D. OTHER SOURCES OF LIFETIME INCOME

In addition to voluntary saving through 401(k) elections and IRAs, individuals can also save money outside of the retirement system. Investment income is generally subject to federal income tax rates of up to 39.6 percent in 2017, however, capital gains and dividends are generally taxed at a preferential tax rate of 0, 15, or 20 percent, depending on the income tax rate that would be assessed on the same amount of ordinary income. Also, there

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121 I.R.C. § 1(h) (1985); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., OVERVIEW OF THE FEDERAL TAX SYSTEM AS IN EFFECT FOR 2016 6 (Comm. Print 2016) (“For 2016, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent on any amount of gain that otherwise would be taxed at a 39.6-percent rate. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. Adjusted net capital gain otherwise
are various tax advantages associated with investments in homes, state and local bonds, annuities, and life insurance. This subpart focuses on two ways that individuals commonly generate lifetime income: 1) systematic withdrawals from an investment portfolio; and 2) annuities.

1. Phased Withdrawals

One of the simplest and most common strategies for managing retirement savings is to invest all of the retirement savings in a diversified portfolio and then use a conservative withdrawal rate and a systematic withdrawal plan (SWP) designed to have a high probability that the retirement savings will last for 20 or 30 years. This phased withdrawal strategy can be used with free-standing retirement savings or with retirement savings in defined contribution plans, IRAs, and those defined benefit plans that permit periodic withdrawals.

In that regard, financial planners often suggest following the so-called “4 percent rule.” The basic idea is to set spending at 4 percent of

\[ \text{taxed at rates greater than 15 percent but less than 39.6 percent is taxed at a 15-}
\text{percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax. Dividends are generally taxed at the same rate as capital gains.} \]
\[ \text{In addition, there is also a 3.8 percent surcharge on the net investment income of certain individuals with incomes over $200,000, which includes capital gains, dividends, and other investment income such as rents. I.R.C. § 1411 (2012). Gains on investments are typically taxed only when they are realized at a sale or exchange. I.R.C. §§ 61, 1001 (2012).} \]
\[ \text{I.R.C. §§ 163(a), 121 (2012) (for example, home mortgage interest is generally deductible, and gains from the sale of a personal residence are often excludable).} \]
\[ \text{I.R.C. § 103 (2012) (interest exclusion).} \]
\[ \text{See I.R.C. § 72 (2012). The individual can exclude a fraction of each annuity payment from income. That fraction (the "exclusion ratio") is based on the amount of premiums or other after-tax contributions made by the individual. The exclusion ratio enables the individual to recover her own after-tax contributions tax free and to pay tax only on the remaining portion of benefits which represents income. The net effect is a deferral of taxation.} \]
\[ \text{I.R.C. § 101(a) (2012) (exclusion for insurance proceeds paid by reason of the death of the insured).} \]
\[ \text{See William P. Bengen, Determining Withdrawal Rates Using Historical Data, J. OF FIN. PLAN., Oct. 1994, 171, 174–175 (explaining, using historical data, why retirees should withdraw no more than 4 percent of their retirement savings} \]
retirement savings and invest those savings in a 50-percent-stock-50-percent-bond portfolio. Each year thereafter, spending is increased to keep up with inflation. For example, assuming that an individual has a $1,000,000 nest egg, in the first year of retirement, she would withdraw 4 percent ($40,000), and each year thereafter that dollar amount would increase to keep up with inflation. Assuming a 3 percent annual inflation rate, annual withdrawals would increase to $41,200 in the second year, $42,436 in the third year, and so on. While there is a possibility of running out of money before death, many financial planners believe this strategy can usually work for 30 years. To minimize the prospect of outliving one’s nest egg in the recent economic recession, however, some financial advisers advised retirees to skip their scheduled inflation adjustments or to withdraw less than 4 percent of their new balances.
Another simple withdrawal strategy is for a retiree to base withdrawals on the retiree’s life expectancy \((e)\). Under the simplest approach, each year the retiree would withdraw one over her life expectancy (i.e., \(1/e\)), but then about half of retirees would run out of money. A better approach would be to recalculate the retiree’s life expectancy each year. For example, a 65-year-old man with a $1-million nest egg and a 17.75 year life expectancy would withdraw around $56,300 in his first year of retirement ($56,300 = $1,000,000 \times 1/17.75 \times 5.63 \text{ percent})$. If he lives ten years to age 75, his life expectancy would then be around 11.03 (not \(7.75 = 17.75 - 10.00\)), and, accordingly, he would then withdraw just 9.07 percent (9.07 = 1/11.03) of the balance in his retirement savings account. There is still a sizable chance of outliving his nest egg, but recalculating his life expectancy makes that risk less likely.

In passing, it should be noted that many pensions and IRAs already make distributions based on life expectancy. In that regard, the required minimum distribution rules require that most retirement plan participants start receiving minimum distributions soon after they reach age 70½, and these distributions are based on life expectancy. In effect, the required minimum distribution rule is the default distribution rule for many pension

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133 Id. (0.090661 = 1/11.03.)

134 See supra note 101 and accompanying text.
plans and IRAs. For example, TIAA has been offering a so-called “Minimum Distribution Option” since 1991.

2. Lifetime Annuities and Deferred Income Annuities

Annuities are another common way to provide lifetime income, and, in general, most analysts believe that lifetime annuities offer better lifetime income security than systematic withdrawals. While the market for annuities is well-developed in the United States, the penetration rate is fairly low—just 8 percent of retirement assets in 2015—and declining in recent years.


See, e.g., Mark Warshawsky, Distribution Methods for Assets in Individual Accounts for Retirees: Life Income Annuities and Withdrawal Rates, 3(2) J. OF RET. 105 (Fall 2015); but see Michael E. Kitces & Wade D. Pfau, The True Impact of Immediate Annuities on Retirement Sustainability: A Total Wealth Perspective (July 15, 2013), http://ssrn.com/abstract=2296867 (suggesting that immediate annuities should only be used to hedge significant longevity risk beyond life expectancy).

See, e.g., Citi GPS: Global Perspectives & Solutions, THE COMING PENSIONS CRISIS 69–70, 80 (Mar. 2016), https://www.citivelocity.com/citigps. The penetration rate can be estimated by dividing the Federal Reserve Board’s estimate of annuity reserves by its estimate of total retirement savings. For example, the Federal Reserve Board reported that at the end of 2015, there were $2.3 trillion in annuities out of a total of $27.3 trillion in household retirement assets, or approximately 8 percent (0.084249 = $2.3 trillion/$27.3 trillion). See supra note 31 and accompanying text.
a. Types of Annuities

There are various types of annuities. One distinction has to do with the way the annuity is designed. With a “fixed annuity,” the insurance company typically promises to make specific dollar payments to the annuitant for the term of the annuity contract, often for life.\(^\text{140}\) On the other hand, variable annuities allow the annuitant to select from a range of investment options, and she can do better if the underlying investments do well, or worse if those investments perform poorly.\(^\text{141}\) It should be noted, however, that many investors buy variable annuities primarily for their tax advantages and rarely elect to turn them into lifetime income streams.\(^\text{142}\)

Another distinction has to do with how long the insurance company makes the annuity payments. For example, term certain annuities pay a given amount per year for a certain number of years, regardless of what happens to


the annuitant over the course of that term. This Article is instead primarily concerned with various types of lifetime annuities, and in this section, we explain the distinction between level-payment fixed lifetime annuities, inflation-adjusted annuities, and deferred income annuities.

i. Fixed Annuities

Annuities are often used to provide lifetime retirement income. For example, for a 65-year-old man who purchased a $100,000 immediate fixed (lifetime) annuity without inflation protection on December 1, 2015, the annual payment would be around $6540 (6.54 percent of the annuity’s purchase price). Because women tend to live longer than men, the annual payments for a 65-year-old woman who elected an immediate fixed annuity on December 1, 2015 would be only $6132 (6.13 percent of the annuity’s purchase price). Unlike ERISA-covered pension plans, insurance companies can price the annuities that they offer to men and women differently.

In addition to lifetime annuities based on a single life, it is also possible to buy lifetime annuities that are based on the joint lives of a couple. For example, for a couple consisting of a 65-year-old man and a 60-year-old woman who purchased a $100,000 immediate fixed annuity without inflation protection on December 1, 2015, the annual payment would be around $5112 (5.11 percent of the annuity’s purchase price).

Many analysts believe that most individuals will get the best value for their investment if they defer their decision to annuitize until age 75 or 80. In that regard, a 75-year-old man who purchased a $100,000

144 See ANNUITY SHOPPER, BUYER’S GUIDE 17 tbl.5 (2016), https://www.immediateannuities.com/pdfs/as/annuity-shopper-2016-01.pdf ($6540 per year = 12 x an average payment of $545 per month).
145 Id. ($6132 = 12 x an average payment of $511 per month).
146 See supra notes 105–106 and accompanying text.
147 But see Mary L. Heen, Nondiscrimination in Insurance: The Next Chapter, 49 GA. L. REV. 1 (2014) (arguing that gender discrimination laws should be expanded to prevent insurance companies from selling gender-based annuities).
148 ANNUITY SHOPPER, BUYER’S GUIDE, supra note 144, at 25 tbl.11 ($5112 = 12 x an average payment of $426 per month).
149 See, e.g., Moshe A. Milevsky, Optimal Annuity Policies: Analysis and Options, 5 N. AM. ACTUARIAL J. 57 (2001); Anthony Webb, Providing Income for
immediate fixed annuity without inflation protection in December of 2015 could get an annuity with an annual payout of $8892; an 80-year-old could get an annual payout of $10,920 and an 85-year-old could get an annual payout of $13,812.\textsuperscript{150} According to the Life Insurance Marketing and Research Association (LIMRA), 73 is the average age of purchasers of single premium immediate annuities (SPIAs)\textsuperscript{151}

ii. Inflation-adjusted Annuities

Inflation-adjusted annuities offer an even better way to hedge against living too long. With inflation-adjusted annuities, annual payments would start out lower than level-payment fixed annuities but could end up higher. For example, if our hypothetical 65-year-old man instead chose an annuity stream with a 3-percent annual escalator, the initial annual payment would be just $4728, but, eventually, the annual payments would exceed the $6540 per year under the level-payment fixed lifetime annuity.\textsuperscript{152}

iii. Deferred Income Annuities

Alternatively, retirees can protect against longevity risk by purchasing deferred income annuities (a/k/a longevity insurance).\textsuperscript{153} The

\textsuperscript{150} ANNUITY SHOPPER, BUYER’S GUIDE, supra note 144 at 21 tbl.7 (age 75: $8892 = 12 \times an average payment of $741 per month), at 22 tbl.8 (age 80: $10,920 = 12 \times an average payment of $910 per month), and at 23 tbl.9 (age 85: $13,812 = 12 \times an average payment of $1151 per month).

\textsuperscript{151} Kerzner, Presentation to Federal Advisory Committee on Insurance, supra note 4, at 22.

\textsuperscript{152} ANNUITY SHOPPER, BUYER’S GUIDE, supra note 144 at 17 tbl.5 (showing average monthly payments to 65-year-old men with a 3-percent-cost-of-living adjustment of $394 per month in the first year of his retirement [$4728 in the first year = 12 \times an average payment of $394 per month]).

typical approach is to buy a deferred income annuity at age 65 that starts making annual payments only if the annuitant lives past age 80 or 85. For example, in February of 2012, a 65-year-old man could invest $100,000 in a MetLife deferred income annuity; and beginning at age 85, he would receive a level lifetime income of $25,451.04 per year. Companies do not offer inflation-adjusted deferred income annuities, but some companies do offer fixed step-ups.

With a relatively small upfront investment, a retiree can secure an income stream that starts sometime in the future, and the retiree can then use the rest of her savings to cover the fixed number of years until the year that the deferred income annuity payments start. There is some risk of running


Memorandum from Hersh L. Stern to author (Feb. 7, 2012) (on file with the author). Alternatively, he could purchase a deferred income annuity that instead starts at age 80 that pays $17,069.40 per year; at age 75 that pays $11,649.84 per year; or at age 70 and pays $8,133.60 per year. Id. See also Abraham & Harris, The Market for Longevity Annuities, supra note 153, at 16 ex.4, 18 (showing various 2014 quotes for immediate and deferred income annuities and noting that “approximately two-thirds of the [deferred income] annuities sold had deferral periods of five years or less, with only 1% having deferral periods in excess of 15 years”).


See, e.g., Michael Kitces, A Fix for Retirement Plan Guessing, FIN. PLAN. (Feb. 24, 2016), http://www.financial-planning.com/news/portfolio/kitces-planning-for-the-long-haul-without-a-crystal-ball-2695826-1.html (discussing various ways to use deferred income annuities to plan for secure lifetime income and showing that deferred income annuities offer better returns than bonds); Stephen Sexauer, Michael W. Peskin & Daniel Cassidy, Making Retirement Income Last a Lifetime, 68 FIN. ANALYSTS J. 74 (2012) (proposing a “decumulation benchmark” that would use about 88 percent of retiree savings to purchase a laddered portfolio of Treasury Inflation-Protected Securities [TIPS] for the first 20 years and would purchase a deferred income annuity with the remaining 12 percent); Rick Wurster, DC 20/20: Pathways to a Secure Retirement, 4 ROTMAN INT’L J. OF PENSION MGMT. 54, 58 (2011) (suggesting that an annuity providing 35 percent real income replacement at age 85 would cost about 7.5 percent of a participant’s average
out of money before the year that the deferred income annuity starts, but that is certainly a more manageable risk than trying to manage one’s retirement savings over the indefinite future.157

Deferred income annuities have gotten a lot more attention since 2014 when the IRS promulgated final regulations authorizing so-called “qualifying longevity annuity contracts” (QLACs).158 Under the regulations, pension plan participants and IRA holders can spend up to $125,000 on QLACs without running afoul of the required minimum distribution rules that normally require individuals to start taking taxable distributions by age 70½.159 All in all, deferred income annuities could help improve retirement income security for elderly Americans.160

account balance at retirement).

Finally, it is worth noting that workers might be able to buy deferred income annuities in installments, starting at a young age. For example, a worker could use a portion of her retirement savings each year to purchase a deferred income annuity that starts at age 65, or at the advanced ages of 70, 75, 80, 85, or even 90. Accordingly, this type of deferred income annuity product could be used to provide retirement benefits that mimic the lifetime pensions provided by traditional defined benefit plans. Milevsky, Real Longevity Insurance with a Deductible: Introduction to Advanced-Life Delayed Annuities, supra note 153.


b. The Market for Annuities

The market for annuities is fairly complex because there are so many types of annuities and so many different purchasers. For example, many companies sell a range of variable annuities, and some of those annuities also provide a guaranteed payment period or a guaranteed minimum payment level.\(^{161}\) In any event, Table 1 shows that $236.7 billion in annuities were sold in the United States in 2015: $133 billion in variable annuities and $103.7 billion in fixed annuities.\(^{162}\) Most of those annuity policies were purchased by businesses or plan sponsors. Indeed, individual annuity sales are a very small portion of the market. In 2015, for example, Table 1 shows that individuals bought just $11.8 billion worth of fixed annuities ($9.1 billion single premium immediate annuities and $2.7 billion deferred income annuities).

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\(^{161}\) Benjamin Goodman & David P. Richardson, *Achieving Retirement Income Security: A Comparison of Guaranteed Lifetime Withdrawal Benefit, Systematic Withdrawal and Partial Variable Annuity Strategies*, TIAA INST. (May 2016), https://www.tiaaorganization.org/public/pdf/rd_achieving_retirement_income_security.pdf. For example, many companies sell variable annuities with guaranteed lifetime withdrawal benefits (GLWB). A GLWB is based on a variable annuity, but it allows investors to lock in a minimum guarantee for life. Mechanically, the investor or retiree deposits or rolls over a sum of money into a variable annuity with subaccounts that are invested in a portfolio of stocks, bonds, and other generic investments. Depending on market performance, that investment portfolio grows (or shrinks). In any event, at retirement, the annuitant starts taking guaranteed withdrawals from the account. Payouts come from the invested funds, but if those funds are ever depleted due to long life and/or poor investment returns, the guaranteed minimum kicks in. On the other hand, if the investment portfolio performs well, payouts can be increased. *See, e.g.*, Jonathan Barry Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, 21 ELDER L. J. 375, 402–03 (2014) and sources cited therein; U.S. Gov’t Accountability Off., *GAO-13-75, Retirement Security: Annuities With Guaranteed Lifetime Withdrawals Have Both Benefits and Risks, But Regulation Varies Across States* (2012), http://www.gao.gov/assets/660/650739.pdf.

annuities), but these individual annuity sales are expected to grow to $21.6 billion in 2019.\footnote{Kerzner, Presentation to Federal Advisory Committee on Insurance, supra note 4, at 19.}

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<th>Table 1: Annuity Industry Estimate</th>
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<td><strong>Type of Annuities</strong></td>
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c. *The Tax Treatment of Annuities*

The federal income tax system generally provides favorable tax treatment of investments in annuities.\footnote{See I.R.C. § 72 (2016); INTERNAL REVENUE SERV., Pension and Annuity Income, supra note 41.} Although the value of an annuity investment grows over time, no tax is imposed until annuity distributions begin. In short, there is no tax on the so-called “inside buildup” until the “annuity starting date.”\footnote{I.R.C. § 72(c)(4) (2015) ( “The annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract.”). See also DAVID L. BRUMBAUGH, CONG. RESEARCH SERV., RS20923, TAXES AND THE “INSIDE BUILD-UP” OF LIFE INSURANCE: RECENT ISSUES (2006), https://archive.org/details/RS20923-crs; ANDREW D. PIKE, CONG.
payment from income.\footnote{166}{I.R.C. § 72(b) (2015).} That fraction (the “exclusion ratio”) is based on the amount of premiums or other contributions made by the annuitant.\footnote{167}{Id.} More specifically, the exclusion ratio is determined at the annuity starting date by dividing the “investment in the contract” by the “expected return under the contract.” The investment in the contract is the annuitant’s premium costs for the annuity,\footnote{168}{I.R.C. § 72(c)(1) (2015).} and the expected return is simply the total amount expected to be received under the annuity.\footnote{169}{I.R.C. § 72(c)(3) (2015).} This method of taxation allows the annuitant to recover her own contributions tax-free.

For example, assume that a 65-year old pays a $100,000 to an insurance company for an immediate fixed annuity that pays $7500 a year for life. Her investment in the contract is $100,000. According to the applicable IRS unisex life expectancy tables, 65-year-olds can expect to live for another 20 years,\footnote{170}{Treas. Reg. § 1.72-9 tbl.V (1995).} and that means that our 65-year-old will have an expected return of $150,000 ($150,000 = 20 × $7500). Accordingly, in each of the first 20 years that our hypothetical annuitant receives $7500, she will exclude $5000 ($5000 = $7500 × $100,000/$150,000). Accordingly, she will report $2500 in income in each of the first 20 years ($2500 = $7500 − $5000). If she lives more than 20 years, all $7500 she receives in year 21 and later years will be taxable, as she will have already recovered all $100,000 of her investment in the contract tax-free.\footnote{171}{I.R.C. § 72(b)(2) (2015).}

On the other hand, if an annuitant dies before she recovers her investment in the contract, she can usually deduct her unrecovered investment in the year of her death.\footnote{172}{I.R.C. §§ 72(b)(3)-(4) (2015).} For example, if our hypothetical annuitant died after receiving seven annual annuity payments, she would have recovered $35,000 of her original $100,000 investment tax-free ($35,000 = 7 × $5000) (and she would have included $17,500 in income [$17,500 = 7 × $2500]). As she had not yet recovered her remaining $65,000 investment in the contract, that $65,000 unrecovered investment can be deducted on the tax return filed for the year that she died.\footnote{173}{I.R.C. § 72(b)(3)(A) (2015).}

\begin{flushright}
\end{flushright}

\begin{flushright}
\textit{166 I.R.C. § 72(b) (2015).}
\textit{167 Id.}
\textit{168 I.R.C. § 72(c)(1) (2015).}
\textit{169 I.R.C. § 72(c)(3) (2015).}
\textit{171 I.R.C. § 72(b)(2) (2015).}
\textit{172 I.R.C. §§ 72(b)(3)-(4) (2015).}
\textit{173 I.R.C. § 72(b)(3)(A) (2015). Literally, if an annuitant dies after the annuity starting date, she can deduct her unrecovered investment on her final income tax return. Id.}
\end{flushright}
The current tax treatment of annuities results in some odd consequences. First, if an annuitant outlives her life expectancy, she will have to pay tax on the full amount of annuity payments that she receives each year for the rest of her life. That greater tax liability in later years may discourage some people from buying annuities, and that greater tax liability in later years is not necessarily balanced out by the deduction for those who die before they have recovered their full investment in the contract.

Second, the rule allowing a deduction for unrecovered investments in the contract also has a quirk that can make deferred income annuities relatively unattractive as retirement income investments. The quirk is that the deduction for unrecovered investments is only available if the annuity payments “cease by reason of the death of an annuitant” . . . “after the annuity starting date” (emphasis added). For example, consider a 65-year-old man who buys a deferred income annuity for $100,000 that will pay him $40,000 a year for life starting at age 85, and further assume that his expected return is $400,000, giving him an exclusion ratio of 25 percent (0.25 = $100,000 investment in the contract/$400,00 expected return). Under the usual annuity-taxation rules, if he lives to 85, he would exclude $10,000 of the first $40,000 annuity payment from income and include the remaining $30,000 in income, and he would continue to do so until—after ten years—he would have recovered his $100,000 investment in the contract (at which point all future $40,000-a-year payments until he died would be fully taxable). Also, if he died at 87, having recovered $30,000 tax-free ($30,000 = 3 × $10,000), he would be allowed to deduct his remaining $70,000 unrecovered investment. Unfortunately, if he dies before reaching age 85, he would not be allowed to deduct any portion of his $100,000 investment in the contract as his death would have occurred before the annuity starting date. In short, individuals who buy deferred income annuities are unable to deduct their losses if they die before the annuity starting date, and that makes deferred income annuities less attractive as retirement income investments. Pertinent here, just 37 percent of 65-year-old men can expect to live to age 85.

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175 Id.
176 Calculations from the Soc’y of Actuaries, Life Expectancy Calculator, supra note 2, show that a 65-year-old man has a 37 percent chance of living 20 years to age 85. In passing, it should be acknowledged that those who buy annuities and especially deferred income annuities are probably healthier than the general population, and it may be more appropriate to use a “healthier” life expectancy table. In that regard, the Society of Actuaries calculator allows us to select such an alternative mortality table (the 2012 Individual Annuitant Mortality tables that were developed from a population of people buying individual immediate annuities), and
d. The Tax Treatment of Life Insurance Proceeds Paid after the Insured’s Death

In passing, it is worth noting that a slightly different set of rules applies when the beneficiary of a life insurance policy elects to take payments for life rather than taking a lump sum payment. In general, life insurance proceeds paid to a beneficiary at the death of the insured are excluded from gross income.\(^{177}\) If the beneficiary instead elects to take annuity-like payments for the rest of her life, then a pro rata portion of each payment is excluded,\(^ {178}\) and the rest is taxable.\(^ {179}\) That pro rata exclusion continues for as long as the beneficiary lives, but if she dies before recovering the full amount that she could have received tax-free, no deduction (or other tax benefit) is allowed for the unrecovered portion.

For example, if a husband dies with a $100,000 life insurance policy naming his wife as the beneficiary, she could exclude all $100,000 from her income. If she instead elected to take $7500 per year payments for the rest of her life—and her life expectancy is 20 years, then she could exclude $5000 each year ($5000 = $100,000/20), and she would report $2500 each year in her gross income. If she lives more than 20 years, she could continue to exclude $5000 each year until she dies. On the other hand, if she died before receiving 20 annual payments, she would not be allowed to take a deduction or other tax benefit for any of her unrecovered excludable amount. For example, if she died after seven years, she would have excluded just $35,000 ($35,000 = 7 × $5000), but she would not be allowed to claim a deduction or other tax benefit for the remaining $65,000.

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\(^{177}\) I.R.C. § 101(a) (2013).


E. **Current Estimates of the Tax Expenditures Associated with Social Security, Pensions, IRAs, and Annuities**

The special tax rules for Social Security, pensions, IRAs, and annuities are routinely identified as “tax expenditures” in the tax expenditure budgets prepared annually by the Office of Management and Budget.\(^\text{180}\) Policymakers often use these tax expenditure estimates as a rough guide to the cost of these special income tax provisions.\(^\text{181}\) For example, Table 2 reproduces the Office of Management and Budget’s 2017 Federal Budget estimates of the revenue losses attributable to the special income tax benefits for Social Security, pensions, IRAs, and annuities (and life insurance savings).\(^\text{182}\) All in all, these tax

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\(^{181}\) Admittedly, however, tax expenditure estimates do not necessarily equal the increase in Federal revenues that would result from repealing the special provisions. See, e.g., Jonathan Barry Forman, *Comparing Apples and Oranges: Some Thoughts on the Pension and Social Security Tax Expenditures*, 5 EMP. RTS. & EMP. POL’Y J. 297, 308 n.50 (2001).

\(^{182}\) OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017, supra note 180, at 228–229, 231. There are also tax expenditures associated with the exclusion of railroad retirement system benefits and veterans’ pensions, not reprinted here.

Most of the items in Table 2 are also identified as tax expenditures in the tax expenditure budgets prepared annually by the Joint Committee on Taxation; however, in its most recent iteration, the Joint Committee on Taxation removed the exclusion for interest on life insurance and annuities from its list. STAFF OF THE J. COMMITTEE ON TAXATION, 114TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2015-2019 (Comm. Print 2015), https://www.jct.gov/publications.html?func=download&id=4857&chk=4857&no_html=1. While the Joint Committee on Taxation acknowledged that a broad interpretation tax expenditures would include the exclusion of investment income on life insurance and annuity contracts, it noted that the Congressional Budget and Impoundment Control Act of 1974 defined tax expenditures as “revenue losses attributable to provisions of the Federal tax laws [emphasis added] which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” The Joint Committee on Taxation then decided that it would no longer include in its tax expenditure budget items for which no provision of the federal tax law specifically allows an exclusion, such as (in its opinion) the exclusion of investment income on life insurance and
expenditures are quite large.\textsuperscript{183} In fact, two of these items are among the top ten largest tax expenditures each year, and five are in the top 20.\textsuperscript{184}


\textsuperscript{184} \textit{OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017}, \textit{supra} note 180, at 243.
Table 2. Estimates of Total Income Tax Expenditures for Fiscal Years 2016, 2017, 2016–2025 (In millions of dollars)

<table>
<thead>
<tr>
<th>Description</th>
<th>2016</th>
<th>2017</th>
<th>2016–25</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exclusion of social security benefits:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social Security benefits for retired workers</td>
<td>26,900</td>
<td>28,280</td>
<td>315,420</td>
</tr>
<tr>
<td>Social Security benefits for disabled workers</td>
<td>8,490</td>
<td>8,580</td>
<td>94,920</td>
</tr>
<tr>
<td>Social Security benefits for spouses, dependents &amp; survivors</td>
<td>4,160</td>
<td>4,310</td>
<td>48,010</td>
</tr>
<tr>
<td><strong>Net exclusion of pension contributions &amp; earnings:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Defined benefit plans</td>
<td>66,600</td>
<td>66,760</td>
<td>622,530</td>
</tr>
<tr>
<td>Defined contribution plans</td>
<td>64,710</td>
<td>65,620</td>
<td>921,480</td>
</tr>
<tr>
<td>IRAs</td>
<td>16,850</td>
<td>16,970</td>
<td>197,420</td>
</tr>
<tr>
<td>Self-Employed plans</td>
<td>28,030</td>
<td>30,800</td>
<td>155,530</td>
</tr>
<tr>
<td>Low and moderate income savers credit</td>
<td>1,280</td>
<td>1,270</td>
<td>13,120</td>
</tr>
<tr>
<td><strong>Exclusion of interest on annuities (and life insurance savings)</strong></td>
<td>18,870</td>
<td>23,380</td>
<td>370,840</td>
</tr>
</tbody>
</table>

**Source:** EXECUTIVE OFFICE OF THE PRESIDENT AND OFFICE OF MANAGEMENT AND BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2017 228 tbl.14-1 (2016).

F. RETIREMENT INCOME ADEQUACY

Social Security is the most common source of income for households aged 65 or older. For example, in 2014, 84.2 percent of households aged 65 or older received Social Security benefits.185 Moreover, Social Security provided more than half of total income for 47.8 percent of aged beneficiary couples that year and 70.7 percent of total income for aged single beneficiaries.186 Only 43.8 percent of households received retirement benefits from sources other than Social Security, and only 61.8 percent received income from other assets.187

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186 SOC. SEC. ADMIN., INCOME OF THE AGED CHARTBOOK, supra note 185, at 9. See also SOC. SEC. ADMIN., FAST FACTS & FIGURES ABOUT SOCIAL SECURITY, 2015, supra note 21 (64 percent of aged beneficiaries received at least half of their income from Social Security in 2013).

187 SOC. SEC. ADMIN., INCOME OF THE AGED CHARTBOOK, supra note 185, at 34.

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All in all, Social Security provided 33.2 percent of personal income of households aged 65 or older in 2014.\textsuperscript{188} Earnings accounted for another 32.2 percent of their income, pensions 20.9 percent, and asset income 9.7 percent.\textsuperscript{189} Of course, as people age, earnings decline, and their inflation-adjusted Social Security benefits become an even larger portion of their incomes.\textsuperscript{190} Still, Social Security alone cannot ensure that Americans will have adequate incomes throughout their retirement years.

Unfortunately, retirement savings may be inadequate for many retirees.\textsuperscript{191} As already mentioned, at any point in time, only about one out of two American workers has a pension plan.\textsuperscript{192} Over their lifetimes, most households will accumulate some retirement savings through current or past work.\textsuperscript{193} Moreover, as households get closer to retirement age, they are even more likely to have accumulated some retirement assets, and recent cohorts of retirees tend to have more retirement assets than previous cohorts.\textsuperscript{194} Still,

\begin{footnotesize}
\begin{enumerate}
\item Id. at 16.
\item Id.
\item See Copeland, \textit{Employment-Based Retirement Plan Participation: Geographic Differences and Trends}, 2013, supra note 45 and accompanying text.
\end{enumerate}
\end{footnotesize}
low participation rates in pension plans, in general, and low contributions rates to 401(k) plans, in particular, have led many analysts to wonder whether current and future generations of retirees will have adequate retirement incomes. Indeed, according to a recent study by the U.S. Government Accountability Office, about 29 percent of households age 55 and older had no retirement savings in 2013 (nor a defined benefit plan). Even among those households that had some retirement savings, the median amount of those savings was just $104,000 for households age 55–64 and $148,000 for households age 65–74, which amounts could be used to purchase modest inflation-adjusted annuities of $310 and $649 per month, respectively. Similarly, according to recent research by the Employee Benefit Research Institute, more than 40 percent of Baby-Boomer and Gen-Xer households are at risk of running short of money in retirement, and more than 15 percent are projected to have less than 80 percent of what they will need. The


Id. at 11, 15.

bottom line is that many Americans are not saving enough in retirement plans or otherwise.199

III. THE REGULATION OF ANNUITIES AND PENSION DISTRIBUTIONS

This Part focuses on the laws and regulations governing retail annuities and pension distributions. This Part also takes a more detailed look at the rules governing pension risk transfer transactions in defined benefit plans.

A. THE REGULATION OF RETAIL ANNUITIES

Individuals can use their freestanding and IRA savings to buy retail annuities in the marketplace. In general, companies offering annuities are subject to comprehensive regulation by state insurance departments.200 With


200 See, e.g., State Regulation of Annuities, INSURED RET. INST., http://www.irionline.org/government-affairs/annuities-regulation-industry-
a typical annuity, an insurance company bears the risk of making certain guaranteed payments, and because insurance companies bear such risks, they are heavily regulated and must maintain adequate reserves.\textsuperscript{201} In addition, all states have state-based guaranty funds that provide protections for annuitants in case the insurance company that sold them the policy becomes insolvent.\textsuperscript{202} While the guarantee limits vary from state to state, every state provides a minimum of $100,000 in benefit protection for annuities, and most states provide at least $250,000 in protection.\textsuperscript{203} These guarantees apply regardless of whether the annuities are in deferred or payout status at the time of the insurance company’s insolvency.\textsuperscript{204}

B. THE REGULATION OF ANNUITIES IN DEFINED BENEFIT PLANS

As mentioned, the default benefit for defined benefit plans is a lifetime pension in the form of an annuity.\textsuperscript{205} Defined benefit plans typically


\textsuperscript{203} Id.

\textsuperscript{204} See supra notes 50–52 and accompanying text.
manage a portfolio of investment assets in a trust and pay those lifetime pension benefits directly from the trust. Alternatively, defined benefit plans sometimes purchase retail annuities in order to meet their pension obligations. While defined benefit plans must offer pension benefit in the form of a lifetime annuity, the plans may also offer lump sum distributions and other payment options at retirement or job separation.

1. Rules Governing Lump Sum Distributions

As mentioned, the default benefit for defined benefit plans is a lifetime pension in the form of an annuity, and for married participants, the default benefit is a qualified joint-and-survivor annuity (QJSA). These days, most defined benefit plans also offer participants some type of lump sum distribution option. Participants who can take a lump sum distribution can generally take that distribution when they terminate employment, or they can defer the distribution until a later date.

When a lump sum alternative is offered to a participant, the minimum lump sum amount must be determined in accordance with certain actuarial “relative valuation” rules. The minimum lump sum must have a value equal to the actuarially-determined present value of the participant’s expected stream of lifetime pension benefits. Those rules ensure that any lump sum distribution is the actuarial equivalent of the promised lifetime pension benefit. Basically, the Internal Revenue Code and related guidance specify the applicable interest rates and mortality tables that must be used to determine the minimum value of the lump sum.

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206 See supra note 40 and accompanying text. Alternatively, a defined benefit pension plan can be designed to invest directly in annuity contracts. Id.
207 See supra notes 50–51 and accompanying text.
208 See supra notes 50–52 and accompanying text. In general, these pay-benefits-in-the-form-of-an-annuity rules also apply to defined contribution plans that are money purchase pension plans. See, e.g., U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN., What You Should Know About Your Retirement Plan, supra note 62, at 18, 36.
210 Id.
212 For an explanation of the mathematics of these present value determinations, see infra Part IV.B.
The plan sponsor must also provide an explanation of the “relative value” of the lump sum when compared to the participant’s lifetime pension benefit. While plan sponsors have a good deal of flexibility about how to convey this information, the explanations “must be expressed to the participant in a manner that provides a meaningful comparison of the relative economic values of the two forms of benefit without the participant having to make [her own] calculations.” For example, if a lump sum is offered, participants must be shown how that lump sum compares with the present value of the lifetime pension benefit.

The Pension Protection Act of 2006 raised the interest rates that defined benefit plans use to determine lump sum distribution amounts and so made lump sum distributions significantly less expensive for plan sponsors. Basically, the Internal Revenue Code used to require plan sponsors to use low 30-year-Treasury-bill interest rates to determine the minimum value of the lump sum, but now plan sponsors can use higher interest rates—calculated using three different corporate interest rates based on segments of the corporate bond yield curve.

Also, until updated mortality tables are required for 2017 or later, plan sponsors can continue to use out-of-date mortality tables that reflect relatively shorter life expectancies than the new mortality tables will.

213 Treas. Reg. §§ 1.417(a)(3)-1, 1.417(e)-1.
216 See, e.g., Notice 2002-26, 2002-1 C.B. 743 (requiring rates of interest based on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year).
provide. In that regard, as life expectancies increase, pensions will need to make monthly payments to participants over more years, and that means lump sum distributions will cost more. Accordingly, shifting to the new mortality tables is expected to result in a 5 to 7 percent increase in pension liabilities for the average plan.

The Internal Revenue Code also generally restricts a defined benefit plan’s ability to cash out a participant’s benefit without the participant’s consent. The plan generally does not need the participant’s consent if the present value of her benefit is $5000 or less; however, if the accrued benefit is over $1000, the plan must also offer the employee the option of rolling such distributions into an IRA or a new employer’s plan. If the participant’s consent is needed and the participant is married, then spousal consent is also required. In any event, when a lump sum distribution is available, the participant is typically given the opportunity to roll it over to another pension plan or to an IRA.

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225 I.R.C. § 402(c) (2014); STAFF OF THE J. COMM. ON TAXATION, 114TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, supra note 37, at 21; INTERNAL REVENUE SERV., Rollovers of Retirement Plan and IRA Distributions
While these lump sum distribution rules provide a variety of protections for plan participants, many analysts worry that employees who take lump sum distributions will dissipate them too quickly.\footnote{226}{See, e.g., Lori Lucas, Plug the Drain: 401(k) Leakage and the Impact on Retirement, Defined Contribution Inst. Inv. Ass’n (Aug. 1, 2011), http://www.dciaa.org/assets/Publications2/WhitePaper/white%20paper_8.1.2011%20dcia%20plug%20the%20drain.pdf; Frolik, Rethinking ERISA’s Promise on Income Security in a World of 401(k) Plans, supra note 59, at 376–82; U.S. Gov’t Accountability Off., GAO-09-715, 401(k) Plans: Policy Changes Could Reduce the Long-Term Effects of Leakage on Workers’ Retirement Savings (2009), http://www.gao.gov/assets/300/294520.pdf.} The worry is even greater when it comes to younger workers who take and spend their lump sum distributions when they change jobs.\footnote{227}{Craig Copeland, Lump-Sum Distributions at Job Change, 30(1) Emp. Benefit Res. Inst. Notes 2 (2009), https://www.ebri.org/pdf/notespdf/EBRI_Notes_Jan09_Rollovers.pdf; Hurd & Panis, The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement, supra note 59.} Participants may take a lump sum distribution (or roll over their account balance into an IRA) and subsequently purchase an annuity in the individual market, but individuals rarely buy annuities voluntarily.\footnote{228}{See infra notes 336–339 and accompanying text.}

2. Rules Governing the Purchase and Monitoring of Annuities

The selection of an annuity provider is a fiduciary decision, and under U.S. Department of Labor Interpretive Bulletin 95-1, the plan sponsor must choose the “safest available” provider.\footnote{229}{29 C.F.R. § 2509.95-1 (2016) (a/k/a Interpretive Bulletin 95-1, Interpretive bulletin relating to the fiduciary standards under ERISA when selecting an annuity provider for a defined benefit pension plan); Bussian v. RJR Nabisco, Inc., 223 F.3d 286, 298 (5th Cir. 2000) (discussing the “safest available” standard); Riley v. Murdock, 83 F.3d 415 (4th Cir. 1996) (declining to apply the “safest available” standard).} The plan sponsor must evaluate a potential annuity provider’s claims-paying ability and creditworthiness but cannot rely solely on ratings provided by insurance rating services. Factors that the plan sponsor should consider include:
The U.S. Department of Labor’s new fiduciary conflict-of-interest rule will also apply to financial advisers who sell annuities to defined benefit plans and plan participants, and it will have a transformative impact on the sales of annuities to defined benefit plans and plan participants. The new rule is almost certain to change the current commission structure of annuities offered to plans and plan participants, and probably for the better (i.e., lower and more transparent commissions and fees).

A plan sponsor also has a duty to monitor the appropriateness of the annuity providers that it selects, but that duty ends when the plan transfers the plan’s liability with respect to the individual’s benefits to that annuity provider.


See supra notes 90–91 and accompanying text.


See also Greg Iacurci, DOL fiduciary rule will transform the annuity industry, INVESTMENT NEWS, (Feb. 21, 2016, 12:01 AM), http://www.investmentnews.com/article/20160221/FREE/160219910/dol-fiduciary-rule-will-transform-the-annuity-industry?issu date=20160221&sid=ANNUITY22016; Michael Kitces, Why The DoL Fiduciary Rule Won’t Kill Annuities, It Will Make Them Stronger!,

230 29 C.F.R. § 2509.95-1(c) (2008).
231 29 C.F.R. § 2509.95-1(b) (2008).
232 See supra notes 90–91 and accompanying text.
233 Stolz, How Annuities Will Be Transformed by DOL Fiduciary Rule, supra note 91.
234 Stolz, How Annuities Will Be Transformed by DOL Fiduciary Rule, supra note 91. See also Greg Iacurci, DOL fiduciary rule will transform the annuity industry, INVESTMENT NEWS, (Feb. 21, 2016, 12:01 AM), http://www.investmentnews.com/article/20160221/FREE/160219910/dol-fiduciary-rule-will-transform-the-annuity-industry?issu date=20160221&sid=ANNUITY22016; Michael Kitces, Why The DoL Fiduciary Rule Won’t Kill Annuities, It Will Make Them Stronger!,

C. THE REGULATION OF ANNUITIES IN DEFINED CONTRIBUTION PLANS

Annuities can also play a role in defined contribution plans. First, defined contribution plans may offer deferred income annuities among their investment options. Second, a defined contribution plan may offer participants the option to annuitize their account balances at retirement or job separation. Third, almost all defined contribution plan participants may take a lump sum distribution (or roll over their account balance into an IRA) and subsequently purchase an annuity.  

1. Rules Governing Lump Sum Distributions

Defined contribution plans are not required to offer annuities, and as already mentioned, most defined contribution plans make distributions in lump sum or periodic distributions rather than lifetime annuities. In that regard, defined contribution plans typically allow lump sum distributions whenever an employee leaves employment—both at retirement or simply upon job separation.  

Plans are not required to offer departing employees a lump sum distribution (at least not until they are eligible to retire), but most plans do. If the accrued benefit of the departing employee is under $5000, the plan is allowed to distribute the accrued amount in a lump sum distribution without the employee’s consent; however, if the accrued benefit is over $1000, the plan must also offer the employee the option of rolling such distributions into an IRA or a new employer’s plan. All in all, departing employees can leave the money in the plan, roll it over into an IRA or other plan, or cash it out and spend it. Many analysts worry about


236 See supra Part II.C.1.b.


238 Id.


employees dissipating their retirement savings when they receive lump sum distributions (or loans) and spend them before retirement.  

2. Rules Governing the Purchase and Monitoring of Annuities

   a. Fiduciary Duties Generally

   When a defined contribution plan does offer an annuity, the selection of an annuity provider is, of course, a fiduciary function. The current safe harbor provides that a defined contribution plan fiduciary satisfies its fiduciary responsibility if the fiduciary:

   (1) engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;
   (2) appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;
   (3) appropriately considers the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract;
   (4) appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the

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241 See, e.g., Lucas, Plug the Drain: 401(k) Leakage and the Impact on Retirement, supra note 226, at 1; Copeland, Lump-Sum Distributions at Job Change, supra note 227, at 2; Hurd & Panis, The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement, supra note 59, at 7.

benefits and services to be provided under the contract; and

(5) if necessary, consults with an appropriate expert or experts for purposes of compliance with these provisions.\textsuperscript{243}

A defined contribution plan sponsor also has a duty to monitor the appropriateness of the annuity providers that it selects, but that duty ends when the plan transfers the plan’s liability with respect to the participant’s benefits to that annuity provider.\textsuperscript{244}

A defined contribution plan is relatively free to impose restrictions on the amount of assets that may be annuitized, even “unpalatable” restrictions.\textsuperscript{245} For example, the plan may require the participant to annuitize either all or none of her account balance.\textsuperscript{246}

The U.S. Department of Labor’s new fiduciary conflict-of-interest rule also applies to financial advisers who sell annuities to defined contribution plans and plan participants.\textsuperscript{247}

b. **Annuity Investments within Defined Contribution Plans**

While a defined contribution plan sponsor can select the investments for its plan, ERISA Section 404(c) generally allows plans to permit individual participants to direct their own investments (a/k/a, “self-directed” or “participant-directed” accounts).\textsuperscript{248} To be eligible for this safe harbor, the

\begin{itemize}
  \item \textsuperscript{244} Field Assistance Bulletin 2015-2, supra note 243; 29 C.F.R. § 2550.404a-4 (2008).
  \item \textsuperscript{245} Brien & Panis, The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement, supra note 59, at 14.
  \item \textsuperscript{246} Id. (noting plan limits may also make it difficult to wait to select an annuity).
  \item \textsuperscript{247} See supra notes 90–91 and accompanying text.
  \item \textsuperscript{248} ERISA § 404(c), 29 U.S.C. §1104(c) (2008) (providing plans with a “safe harbor” from liability for losses that a participant suffers in their 401(k) accounts to the extent that the participant exercises control over the assets in her 401(k) account). See also U.S. DEP’T OF LABOR, EMP. BENEFITS SEC. ADMIN., Meeting Your Fiduciary Responsibilities, supra note 87, at 6; INTERNAL REVENUE SERV., Retirement Topics - Participant-Directed Accounts (Oct. 7, 2015),
\end{itemize}
plan must provide the participant with the opportunity “to exercise control over assets in his individual account” and “to choose, from a broad range of investment alternatives.” The plan must also provide the participant with “the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan,” including information about transaction fees and expenses. Also, “the act of designating investment alternatives in an ERISA Section 404(c) plan is a fiduciary function,” and “in deciding whether and to what extent to invest in a particular investment, or to make a particular fund available as a designated investment alternative, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income.” Defined contribution plans can include fixed and variable annuities among their investment alternatives.

When a plan sponsor allows participants to direct their own investments, the plan sponsor must also choose a default investment for workers who do not otherwise direct their own investments. Historically, plan sponsors used low-yield, stable-value bond funds for that purpose, but the Pension Protection Act of 2006 amended ERISA Section 404(c) to improve the default investments for workers who do not otherwise direct their own investments. That law—and the U.S. Department of Labor’s regulation—encouraged employers to replace their low-yield, stable-value bond funds with balanced funds (funds with an unchanging mix of stocks


254 Pension Protection Act of 2006, supra note 67 (amending ERISA § 404(c), 29 U.S.C. § 1104(c) (2008)).
and bonds) and life-cycle funds (funds that gradually shift their investments from stocks towards bonds as workers age). More specifically, the final regulation provides for four types of so-called “qualified default investment alternatives” (QDIAs) and also clarifies that a QDIA may be offered through variable annuity contracts or other pooled investment funds. In response to these rule changes, defined contribution plans have generally moved away from stable-value bond funds and towards target date funds, but plan sponsors can also offer annuities.

Recently issued guidance makes it easier for defined contribution plan sponsors to offer annuities. More specifically, if certain conditions are satisfied, plan sponsors can offer, as investment options, a series of target date funds that include deferred income annuities among their assets, even if some of the target date funds within the series are available only to older participants. In related guidance the U.S. Department of Labor noted that target date funds that serve as qualified default investment alternatives may include annuities as part of their investment portfolios.

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258 See, e.g., TIAA-CREF Financial Services, The Case for Guaranteed Annuities in Defined Contribution Plans, supra note 252.


261 U.S. Dep’t of Labor, Emp. Benefits Sec. Admin., Information letter from Phyllis Borzi, Assistant Secretary for EBSA, U.S. Department of Labor, to Mark
Regardless of how participants invest over the course of their careers, at retirement or job separation, a defined contribution plan can offer an in-plan annuity distribution option.\textsuperscript{262} To avoid the fiduciary risks that come from selecting and monitoring annuity providers, however, plan sponsors can instead offer annuities outside the plan as an IRA rollover option.\textsuperscript{263}

D. \textbf{THE REGULATION OF ANNUITIES IN INDIVIDUAL RETIREMENT ACCOUNTS}

Individuals can also use their IRAs to buy annuities. For example, an individual might roll over a lump sum pension distribution into an IRA and then have the IRA purchase an annuity. For that matter, the individual could roll over the funds directly to an “IRA annuity” offered by an insurance company.\textsuperscript{264} Having an IRA purchase an immediate fixed (lifetime) annuity will usually satisfy the required minimum distribution rules.\textsuperscript{265} The U.S. Department of Labor’s new fiduciary conflict-of-interest rule will also apply to financial advisers who sell annuities to IRA holders.\textsuperscript{266}

E. \textbf{PENSION RISK TRANSFERS}

Over the years, defined benefit plan sponsors have found it challenging to manage the risks associated with those plans. This has been

\begin{itemize}
\item \textsuperscript{262} See, e.g., Steve Utkus, \textit{Annuity—or not?}, \textsc{Vanguard Blog for Inst. Investors} (Nov. 20, 2015), http://vanguardinstitutionalblog.com/2015/11/20/annuity-or-not/.
\item \textsuperscript{263} Id.
\item \textsuperscript{264} See, e.g., Hersh Stern, \textit{Can I Buy An Annuity With My IRA or 401k?}, \textsc{ImmediateAnnuities} (Aug. 7, 2016), https://www.immediateannuities.com/rollover-ira-or-401k/.
\item \textsuperscript{265} Treas. Reg. § 1.401(a)(9)-6 (2014). See, e.g., Hersh Stern, \textit{Required Minimum Distribution (RMD)}, \textsc{ImmediateAnnuities} (Aug. 10, 2016), https://www.immediateannuities.com/required-minimum-distribution/ (noting that the required minimum distribution (RMD) rules generally require plan participants to begin taking distributions soon after they reach age 70½). \textit{See supra} note 101 and accompanying text.
\item \textsuperscript{266} \textit{See supra} notes 90–91 and accompanying text.
\end{itemize}
particularly true since the Financial Accounting Standards Board (FASB) began requiring corporate employers to recognize the funding obligations associated with their defined benefit plans. Also, recent fluctuations in the national economy have resulted in changes in the value of plan assets and in market interest rates, which, in turn, have led to volatility in the funded status of defined benefit plans and in the pension contributions that plan sponsors are required to make. In general, corporate employers have responded by “freezing,” terminating, or replacing their traditional defined benefit plans. Many plan sponsors have also chosen to reduce their risks by managing their plan assets with so-called “liability driven investing” (LDI). Finally, many plan sponsors are now focused on de-risking their defined benefit plans—pension risk transfer strategies that transfer risk to insurance companies by purchasing annuities for participants (insurance annuity risk transfers) or that transfer risk to participants by making lump sum distributions to the participants (lump sum risk transfers).

267 See, e.g., FASB Improves Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, FIN. ACCT. STANDARDS BD. (Sep. 29, 2016), http://www.fasb.org/jsp/FASB/FASBContent_C/NewsPage&cid=900000004155.


1. An Overview of Risk Transfer Strategies for Defined Benefit Plans

Defined benefit plan sponsors can significantly reduce their financial risks by engaging in lump sum risk transfers and insurance annuity risk transfers. In a lump sum risk transfer, the participant gets a lump sum distribution that has a value that is the actuarial equivalent of the remaining expected payments under her pension. In an insurance annuity risk transfer, the participant gets an insurance company annuity instead of her pension. In both types of risk transfers, the plan sponsor is able to reduce the size of its pension content/uploads/2013/03/Pension-Settlements-through-TV-Windows-3_18_13.pdf; CFO Research & Mercer, Taking the Next Step in Pension Risk Management, CFO.COM (July 2015), http://www.cfo.com/research/index.cfm/download/14717490; Marcia Wagner, De-Risking Strategies, PLAN SPONSOR (Feb. 2016) http://www.plansponsor.com/MagazineArticle.aspx?id=6442517918; Rebecca Moore, Risk Capture, PLAN ADVISER 50 (Jan.–Feb. 2016), http://www.planadviserdigital.com/planadviser/january_february_2016?sub_id=F07mtVh0axU7&folio=50&pg=54#pg54; Timothy J. Geddes, Bradley B. Howard, Anthony G. Conforti & Allison R. Steinmetz, Pension Risk Transfer: Evaluating Impact and Barriers for De-Risking Strategies, DELoitte 6 (2014), https://www.soa.org/Files/Research/Projects/2014-pension-risk-transfer-study.pdf (noting that pension de-risking strategies fall under three main categories: plan design; funding and investment policy; and liability management); Paul M. Secunda & Brendan S. Maher, Pension De-Risking, 93(3) WASHINGTON U. L. REV. 733 (2016).

272 See, e.g., supra note 271 and accompanying text. Note that defined contribution plans do not need to engage in risk transfer strategies. A defined contribution plan sponsor’s principal financial obligation is to fully fund its plan by making the required (defined) contributions. Thereafter, the plan sponsor is required to manage the plan’s assets as the individual account balances grow and to make distributions from those individual accounts when the participants retire or terminate their employment, but, unlike a defined benefit plan sponsor, a defined contribution plan sponsor has no further financial obligations (absent a breach of fiduciary duties). Defined contribution plan sponsors can, however, “outsource” many of their plan administration duties to third-party administrators, but that is not at all like the de-risking of financial risks by defined benefit plans). U.S. DEP’T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, Outsourcing Employee Benefit Plan Services (Nov. 2014), http://www.dol.gov/ebsa/pdf/2014ACreport3.pdf.
plan and its pension costs, for example, by reducing its PBGC premiums. In short, pension risk transfers reduce risks for defined benefit plan sponsors.

At the same time, however, pension risk transfers generally increase risks for participants and often push them away from receiving streams of lifetime income. For example, participants who receive lump sum distributions must bear all of the longevity risk for making their money last for the rest of their lives; they must bear all the costs and risks of managing their investments; and their assets are no longer entitled to the creditor and other protections of ERISA. Participants who receive insurance company annuities have their PBGC guarantees replaced by the less generous guarantees of state guaranty funds.

2. The Recent (and Coming) Increase in Pension Risk Transfers

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273 See, e.g., PENSION BENEFIT GUAR. CORP., Premium Rates, supra note 102 (noting plan sponsors have to pay both per-participant PBGC premiums and a variable-rate premium that is based on the plan’s level of funding); The Bipartisan Budget Act of 2015, Public Law No. 114-74, 129 Stat. 584 (providing for significant increases in PBGC premiums). Id. For example, for single-employer plans, the per-participant flat premium rate for plan years beginning in 2017 is $69 for single-employer plans and the variable-rate premium (VRP) for single-employer plans is $34 per $1000 of unfunded vested benefits (UVBs). PENSION BENEFIT GUAR. CORP., Premium Rates, supra note 102.

In recent years, we have seen a significant increase in these pension de-risking transactions. According to one recent study of private pension plans, more than one million participants were affected by de-risking from 2009–2013. There were $8.5 billion in pension buy-out transactions in 2014, and more than $8 billion in the first three-quarters of 2015 and de-risking transactions are expected to continue to rise.

Increasingly, plan sponsors—especially those with frozen defined benefit plans—view their defined benefit plans as legacy liabilities that are no longer a strategic part of their current compensation packages. Through lump sum risk transfers and insurance annuity risk transfers, plan sponsors can reduce the number of plan participants. As a result a plan sponsor can save money by reducing the plan’s administrative costs and its ever-increasing PBGC premiums. Removing participants from the plan also reduces the size of the pension and so reduces the impact of market volatility on pension plan funding and contribution rates (and on corporate balance sheets). Also, as already-mentioned, until the new mortality table regulations come into effect in 2017 or later, plan sponsors can still use the currently-required mortality tables to calculate lump sums—tables that reflect shorter life expectancies than the new mortality tables. All in all, it is less expensive for plans to enter into lump sum risk transfers sooner rather than later.


279 See, e.g., PENSION BENEFIT GUAR. CORP., Premium Rates, supra note 102 (showing scheduled increases through 2019).

280 See supra notes 218–220 and accompanying text.

281 On the other hand, there is no similar cost savings for an insurance annuity risk transfer as insurance companies have already taken the new life expectancy
Lump sum risk transfers and insurance annuity risk transfers are still relatively expensive in today’s low-interest-rate environment, and they present significant challenges for currently-underfunded defined benefit plans. Pertinent here, higher interest rates generally have a bigger effect on a plan’s liabilities than on its assets. Among other things, that means that (if and) when market interest rates increase, pension plan funding ratios will improve. As a result, many currently underfunded plans would “become” fully funded, and once plans are 110 percent funded, many observers believe that many of those plans would then implement de-risking and termination strategies. As more fully explained in Part III.E.3.a below, it is fairly easy for a plan sponsor to terminate a fully funded plan, and participants in those “standard terminations” generally get lump sum distributions or insurance annuities: there is no way for a participant to stay with a plan that is terminating.

3. The Current Rules Governing Pension Risk Transfers

A variety of ERISA rules can have an impact on lump sum risk transfers and insurance annuity risk transfers.

a. Standard Terminations

It is fairly easy for a plan sponsor to terminate a fully funded defined benefit plan. In general, these standard terminations involve purchasing projections into account in pricing their annuities. Once a plan adopts the new mortality tables, however, annuities will look relatively better compared to the plan’s liability.


283 Rich White, Is Your Defined-Benefit Pension Plan Safe?, INVESTOPEDIA (Feb. 19, 2008), http://www.investopedia.com/articles/retirement/08/safe-db-plan.asp (noting a defined benefit plan’s funding ratio is the ratio of its assets to its liabilities).

284 See, e.g., Sammer, Companies Eye Pension De-Risking, supra note 271; see also Taking the Next Step in Pension Risk Management, MERCER 4 (July 2015), http://www.mercer.com/content/dam/mercer/attachments/global/Retirement/mercer-cfo-research-pension-risk-survey-2015.pdf (showing that a large percentage of the 213 large companies surveyed were likely or very likely to undertake risk transfers in 2015 or 2016).

annuities from an insurer, although participants can also be offered lump sum distributions.\textsuperscript{286} A terminating plan can only require a participant to accept a lump sum if the present value of her benefit is $5,000 or less.\textsuperscript{287} A typical standard termination involves numerous steps including: calculating individual participant benefit amounts and payment form options, communicating information to plan participants, and distributing the assets. The whole process typically takes 12 to 18 months.\textsuperscript{288}

Unless the participant elects otherwise, she will receive an insurance annuity that is equivalent to her pension. As already mentioned, the selection of an annuity provider is a fiduciary decision, and the plan sponsor must choose the safest available provider.\textsuperscript{289} A key step in any standard termination is providing an individualized notice of plan benefits to each participant.\textsuperscript{290} These notices of plan benefits include general information about the plan and the data used to calculate each participant’s benefit, and they may also include the plan’s benefit election form. When a lump sum alternative is offered to a participant, the minimum lump sum amount must be determined in accordance with the relative valuation rules, and the notice of plan benefits must explain the relative value of the lump sum when compared to the participant’s lifetime pension benefit.\textsuperscript{291}


\textsuperscript{288} Brickhouse, \textit{Path to Defined Benefit Plan Termination, supra} note 285, at 1.

\textsuperscript{289} See \textit{supra} Part III.B.2.

\textsuperscript{290} 29 C.F.R. § 4041.24 (2015).

b. Lump Sum Risk Transfers

In a typical lump sum risk transfer, the employer amends its defined benefit plan to provide participants with a choice between the lifetime pension benefit promised by the plan and a lump sum distribution that has an actuarially-equivalent present value. Usually, the employer makes its “lump sum window” offer available to separated participants (also known as terminated deferred vested participants), and they are given a window of time (e.g., 90 days) to make their choice. For example, a separated participant who is not yet in pay status could be offered a lump sum that is the actuarial equivalent of her promised lifetime pension benefit. As more fully explained in Part V.A.5 below, however, while that lump sum is the actuarial equivalent of her promised pension, because of the way that retail annuity markets work, that lump sum could almost never be enough to buy a retail annuity that would replicate the promised lifetime pension benefit.

ERISA and the Internal Revenue Code impose a number of limits on the ability of plan sponsors to engage in lump sum risk transfers. At the outset, a plan sponsor’s decision to implement a lump sum risk transfer is a matter of plan design that is viewed as a settlor function rather than a fiduciary function. On the other hand, when the plan sponsor implements that lump sum risk transfer, the plan sponsor acts as a fiduciary.

Also, whenever the plan sponsor makes a lump sum distribution, the plan sponsor must comply with the relative valuation rules. Also, as already-mentioned, until the new mortality table regulations come into effect in 2017 or later, plan sponsors can still use the currently-required mortality

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292 See, e.g., supra note 271 and accompanying text.
tables to calculate lump sums—tables that reflect shorter life expectancies than the new mortality tables.297

The Internal Revenue Code used to require plan sponsors to use low 30-year-Treasury-bill interest rates to determine the minimum value of the lump sum, but now plan sponsors can use higher interest rates—calculated using three different corporate interest rates based on segments of the corporate bond yield curve.298 These higher “applicable interest rates” have made lump sum distributions less expensive for plan sponsors—and less generous for participants. In addition, the interest rules permit plan sponsors to select an applicable interest rate from up to 17 months prior to the month in which the lump sum offer is made. That means that a plan sponsor can gain a financial advantage for itself by selecting a so-called “lookback” interest rate from up to 17 months earlier—when that interest rate is higher (and so results in lower lump sums) than the rate that prevails at the time the lump sum offer is made.299

Another rule lets plan sponsors ignore many additional pension plan benefits when calculating lump sum distribution amounts.300 For example, a plan sponsor can calculate the lump sum for a separated participant based on that participant’s normal retirement benefit, even though that participant might have eventually been eligible for a subsidized early retirement benefit.301 The Pension Protection Act of 2006 added new benefit restrictions that generally prohibit pension risk transfers that result in the plan having a funding ratio after the transaction that is below 80 percent: basically, defined benefit plans that fall below 80 percent are prevented from paying out lump sums.302

Historically, plan sponsors have usually implemented a lump sum strategy by offering the lump sum to separated participants, but more recently plans were also offering lump sums to retirees already in pay status (e.g., already receiving monthly pension benefits).303 Now, however, IRS

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297 See supra notes 218–220 and accompanying text.
298 See supra notes 215–217 and accompanying text.
299 Once an interest rate or other variable is set in a plan, it may later end up working against the plan sponsor, for example, if interest rates increase after the lump sum window offer locks in at a relatively lower interest rate.
300 See, e.g., U.S. DEP’T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, Private Sector Pension De-risking and Participant Protections, supra note 270, at 21.
301 Id.
303 See, e.g., U.S. DEP’T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND
Notice 2015-49 prevents plan sponsors from implementing lump sum risk transfers for retirees in pay status. More specifically, Notice 2015-49 informs taxpayers that the Treasury and the IRS intend to amend the required minimum distribution rules to prohibit defined benefit plans from replacing ongoing annuity payments with a lump sum payment or any other form of accelerated payment.

All in all, ERISA and the Internal Revenue Code provide a number of protections and disclosures for participants (and beneficiaries) who are offered lump sum alternatives to their lifetime pension benefits. The following disclosures are currently required in a lump sum risk transfer:

PENSION BENEFIT PLANS, Private Sector Pension De-risking and Participant Protections, supra note 270, at 16.


I.R.C. § 401(a)(9) generally requires plans to make minimum required distributions to retirees over age 70½, and it is clear that the regulations contemplated in Notice 2015-49 will bar lump sum distributions to those retirees over age 70½ who are in pay status. On the other hand, some analysts wonder whether those regulations will be broad enough to reach retirees under age 70½. See, e.g., IRS Shuts Down Pension Plan De-Risking Technique of Offering Lump Sums to Retirees in Pay Status, VENABLE (July 27, 2015), https://www.venable.com/irs-shuts-down-pension-plan-de-risking-technique-of-offering-lump-sums-to-retirees-in-pay-status-07-27-2015/. In passing, it should be noted that Notice 2015-49 marks a reversal of the position that the IRS had taken in a number of private letter rulings—rulings that, in effect, had permitted plan sponsors to offer lump sum distributions to participants already in pay status. See, e.g., I.R.S. Priv. Ltr. Rul. 401.06-01 (Apr. 19, 2012); I.R.S. Priv. Ltr. Rul. 201228051 (Apr. 19, 2012).

In addition, plan sponsors and their advisers typically provide additional communication materials. Needless to say, choosing between an annuity and a lump-sum payout is a “cognitively challenging task.”


308 Id.


c. Insurance Annuity Risk Transfers

In an insurance annuity risk transfer, the plan sponsor replaces the participants’ pension benefits with retail annuities.\(^{314}\) Basically, the plan sponsor purchases a group annuity contract, and the insurer distributes annuity certificates to the covered individuals.\(^{315}\) Under the minimum funding rules, however, the plan cannot purchase the group annuity unless the plan remains at least 80 percent funded after the transaction.\(^{316}\) As with standard terminations, the selection of an annuity provider is a fiduciary function, and the plan sponsor must choose the safest available provider.\(^{317}\) After the distribution of the certificates to individual plan participants, those individuals cease to be covered by the plan.\(^{318}\) That should also free the plan sponsor from any further fiduciary responsibilities with respect to those former participants.\(^{319}\)

Insurance annuity risk transfers totaled $14.4 billion in 2015, up 54 percent from the previous year.\(^{320}\) Buy-out products accounted for $13.6 billion (95 percent) of the total group annuity risk transfer market in 2015;

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\(^{316}\) *Id.* at 4; ERISA § 206(g), 29 U.S.C. § 1056(g) (2012); I.R.C. § 436(c) (2012).

\(^{317}\) See supra Part III.E.3.a; see also Ellen Shaer, *Pension Plans: To Terminate or Not to Terminate*, CAPTRUST (Feb. 29, 2016), http://www.captrustadvisors.com/resources/institutional-consulting/to-terminate-or-not-to-terminate/.


\(^{319}\) 29 C.F.R. § 2509.95-1(b) (2015).

and single premium buy-ins accounted for just $7.2 million of risk transfers.\textsuperscript{321}

4. The ERISA Advisory Council’s Recent Focus on Model Notices and Disclosures for Pension Risk Transfers

Building on its prior work,\textsuperscript{322} the ERISA Advisory Council recently focused on the information that participants need to make informed decisions when they are faced with lump sum risk transfers and insurance annuity risk transfers.\textsuperscript{323} More specifically, in 2015, the ERISA Advisory Council developed draft model notices and disclosures that can be used by plan sponsors, participants, and the public.\textsuperscript{324} On November 4, 2015, the ERISA Advisory Council presented its findings to the U.S. Department of Labor, and its final report includes model notices for lump sum risk transfers and for insurance annuity risk transfers.\textsuperscript{325} In the end, the guidance that is

\textsuperscript{321} Id. See also John Manganaro, Pension Risk Transfers Topped $14 Billion Last Year, PLANADVISER (Feb. 29, 2016), http://www.planadviser.com/Pension-Risk-Transfers-Topped-14-Billion-Last-Year/.

\textsuperscript{322} U.S. DEP’T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, Private Sector Pension De-risking and Participant Protections, supra note 270.


ultimately issued by the U.S. Department of Labor may have a significant impact on the size and nature of the defined benefit pension plan system and on the lifetime incomes of its participants.\footnote{Ideally, those disclosure requirements should be designed to give participants the information that they need to make informed decisions. At the same time, however, those disclosure requirements should not be so burdensome on plan sponsors that it spurs them to terminate their plans.}

IV. THE ROLE FOR ANNUITIES AND OTHER LIFETIME INCOME MECHANISMS

A. AN OVERVIEW OF THE ROLE OF ANNUITIES

As Part II.C.3 above showed, traditional defined benefit pension plans have been in decline for decades. Individuals now have the primary responsibility to participate in, contribute to, and manage their retirement savings accounts throughout their working years; and they must also manage all of their retirement savings throughout their retirement years. These are daunting tasks.\footnote{See, e.g., Pamela Perun, Retirement Savings: Confronting the Challenge of Longevity, THE ASPEN INST. INITIATIVE ON FIN. SEC. (2010), http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/ConfrontingLongevity_AspenIFS.pdf.} To have adequate income throughout retirement, individuals have to make good financial choices through their working years and beyond. They need to make wise choices about when to retire, when to claim Social Security benefits, how to plan for an unknown length of retirement, how to plan for medical expenses and long-term care, how to use a home to provide retirement income, how to manage a retirement portfolio, and how to convert accumulated retirement savings into a lifetime income stream.\footnote{See, e.g., Craig Copeland, Pension Income of the Elderly and Characteristics of Their Former Employers, 28(3) EMP. BENEFIT RES. INST. NOTES 2 (2007), http://actuary.org/files/Retiree_Choices_IB_102215.pdf.}

That is where traditional pensions, annuities, and similar lifetime income products come in. Although estimates vary, it seems that relatively few retirees receive income from traditional pensions and annuities.\footnote{See, e.g., Retiree Lifetime Income: Choices & Considerations, AM. ACAD. OF ACTUARIES 1, 1–7 (Oct. 2015), http://actuary.org/files/Retiree_Choices_IB_102215.pdf.}
According to one estimate, in 2010, 44 percent of retirees received income from a traditional pension and another 10 percent received income from an annuity.330 Another study suggests that only around one-third of retirees receive income from annuities, but for the majority, these instruments provide just 4 percent of their income.331

It is not altogether clear what the “right” level of annuitization is.332 Studies do show that annuitization helps reduce poverty in old age333 and that retirees who receive lifetime income from annuities or traditional pensions were generally more satisfied than those without such lifetime income.334 All in all, while some individuals with low levels of retirement savings might be better off using their savings for emergencies rather than annuitizing them,335


335 See, e.g., Cotton, Retirement Savings and Annual Spending, supra note 130; STAFF OF THE J. COMMITTEE ON TAXATION, 114TH CONG., PRESENT LAW AND regulate on spending.491 It is not altogether clear what the “right” level of annuitization is.492 Studies do show that annuitization helps reduce poverty in old age493 and that retirees who receive lifetime income from annuities or traditional pensions were generally more satisfied than those without such lifetime income.494 All in all, while some individuals with low levels of retirement savings might be better off using their savings for emergencies rather than annuitizing them.
it seems likely that many individuals would be better off if more of their retirement savings was annuitized.

Unfortunately, people rarely choose to buy annuities voluntarily.\textsuperscript{336} The demand for annuities is significantly lower than expected, and this shortfall has come to be known as the “annuity puzzle.”\textsuperscript{337} Some of the reasons for the low demand for annuities include: the existence of alternative annuities such as Social Security, Supplemental Security Income, and traditional defined benefit plans; a willingness to rely on phased distributions from defined contribution plans, IRAs, and other retirement savings vehicles; the desire to leave bequests; the incompleteness or inefficiencies in the retail annuity market that lead to poor prices for retail annuities; and the behavioral and cultural challenges involved in getting individuals to make decisions about complex investments like annuities.\textsuperscript{338} There are also

\textbf{BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS, supra note 37, at 34 (noting that for some individuals Social Security benefits may provide sufficient lifetime retirement income).}


Before moving on to considering options for reforming the legal rules governing annuities and pension distributions in the United States, this Part of the Article provides a little bit more background on annuities and annuitization. At the outset, this Part explains the mathematics of converting a lump sum into an annuity (and vice versa) and looks at how retail annuities compare with actuarially fair annuities.\footnote{An actuarially fair annuity is one without insurance agent commissions or insurance company reserves, risk-taking, and profits. See also Guan Gong & Anthony Webb, Evaluating the Advanced Life Deferred Annuity—An Annuity People Might Actually Buy 1 n.1, B.C. CTR. FOR RET. RES. (Working Paper No. 2007-15, June 2007), http://crr.bc.edu/wp-content/uploads/2007/09/wp_2007-15.pdf (defining “an actuarially fair annuity as one whose expected return, discounted by an interest rate and annual survival probabilities derived from population mortality tables, equals the premium paid”).} This Part also explores the role of annuitization around the world. Finally, this Part explores some of the cultural and economic challenges to increasing annuitization in the United States.

B. THE MATHEMATICS OF CONVERTING A LUMP SUM INTO AN ANNUITY (AND VICE VERSA)

The mathematics of converting a lump sum into an actuarially fair lifetime annuity is pretty straightforward. If an individual has a fixed principal sum to invest today, and we know the interest rate that she can earn and how long she is expected to live, we can determine the annuity amount
that that person (i.e., the annuitant) will receive each period. For example, if an individual has $100,000 to invest in an annuity today, can earn 5 percent interest per year, and can expect to receive 20 annual annuity payments (i.e., live for 20 years), a simple annuity calculator shows that each annual annuity payment would be $8024.26. Annuities typically make monthly payments, but the mathematical principles are the same for yearly or monthly annuities.

By the same token, the mathematics of converting a lifetime annuity into a lump sum is also quite straightforward. Basically, a lump sum value is determined by converting a stream of projected future benefit payments into a present value. Again, the mathematics is pretty straightforward: we just need to know the applicable interest rate and the number of future benefit payments that the individual expects to receive. The interest rate (also known as the discount rate) is the rate of return that can be earned on the investment, and it is determined by market forces. The number of future benefit payments that the individual is expected to receive is extrapolated from a mortality table. In our example, when the discount rate is 5 percent, the present value of a stream of 20 annual payments of $8024.26

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341 The general formula to solve for the periodic annuity amount is: \( w = \frac{P(1 + r)^{Y-1} - r}{(1 + r)^Y - 1} \), where \( P \) is the present value (= starting principal) of a stream of annual withdrawal amounts (\( w \)) given an interest rate (\( r \)) over a number of Years (\( Y \)). See, e.g., MONEY CHIMP, Annuity, http://www.moneychimp.com/articles/finworks/fmpayout.htm (last visited July 21, 2016).

342 See MONEY CHIMP, Annuity Calculator, http://www.moneychimp.com/calculator/annuity_calculator.htm (last visited July 21, 2016) (starting Principal: $100,000.00; growth rate: 5 percent; years to pay out: 20 years; payouts at: the end of each year; to get Annual Payout Amount = $8024.26).

343 See, e.g., U.S. GOV'T ACCOUNTABILITY OFF., GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS, supra note 268, at 60.

344 Here is a very simple present value example. Suppose you have $1000 today, and you can earn 10 percent annual interest on an investment. That means you could earn $100 interest in a year \( ($100 = 10 \text{ percent} \times $1000) \), and if you made that investment and held it for one year, you would have $1100 at the end of the year \( ($1100 = $1000 + $100) \), and the present value of the right to receive $1100 in one year is $1000. Similarly, if you kept your money in that investment for another year (two years total), it would grow to $1210 \( ($110 = 10 \text{ percent} \times $1100; $1210 = $1100 + $110) \); and the present value of the right to receive $1210 in two years is $1000. The general formula for the present value of a stream of annuity payments is: \( P = \frac{w[(1 + r)^Y - 1]}{[(1 + r)^Y]r} \) where \( P \) is the present value (= starting principal) of a stream of annual withdrawal amounts (\( w \)) given an interest rate (\( r \)) over a number of Years (\( Y \)), see, e.g., MONEY CHIMP, Annuity, supra note 341.
commencing one year from today is $100,000. In short, the present value of a 20-year, $8024.26-per-year annuity is $100,000 (that is, when a 5 percent interest rate and a 20-year life expectancy are the correct actuarial assumptions). Accordingly, $100,000 would be the minimum actuarially-equivalent lump sum that must be offered to a participant getting a lump sum distribution instead of an $8024.26 per year pension.

C. RETAIL ANNUITIES VERSUS ACTUARILY FAIR ANNUITIES

Compared to actuarially fair annuities, retail annuities can be quite expensive. Indeed, experts estimate that the typical insurance company lifetime annuity has a 12 percent “load” factor due to the combination of administrative expenses and adverse selection. That is, the typical retail lifetime annuity provides benefits that are worth just 88 percent of an actuarially fair annuity (i.e., a “money’s worth ratio” of 88 percent). Put differently, the payouts from actuarially fair annuities would be around 15 percent higher than what can actually be purchased in current annuity markets.

345 See Money Chimp, Present Value of an Annuity Calculator, http://www.moneychimp.com/calculator/present_value_annuity_calculator.htm (last visited July 21, 2016) (Annual payout: $8024.26; growth rate: 5 percent; years to pay out: 20 years; make payouts at: the end of each year; calculate and get present value = $100,000.02).

346 See supra Parts III.B.1 & III.E.3.b (discussing the relative valuation rules used to compute lump sum payouts).

347 See supra note 340 and accompanying text.

348 See, e.g., Mark J. Warshawsky, Retirement Income: Risks and Strategies 66 (2012) (“[D]ue to a combination of administrative costs and selection effects, the nominal annuity is assumed to have a money’s worth ratio of 0.88, that is, the couple faces a 12 percent load factor on their annuity purchase.”).

349 Id.

350 Id.; see also James Poterba, Steven Venti & David Wise, The Composition and Drawdown of Wealth in Retirement, 25(4) J. ECON. PERSP. 95, 102 tbl.3 (Fall 2011) (showing that the actuarially fair lifetime annuity for a 65-year-old-man in 2008 was 9.95 percent while the Annuity Shopper price for a retail lifetime annuity at that time was just 8.46 percent, indicating a load factor of 17.6 percent [17.6 percent = 9.95 percent/8.46 percent – 100 percent]); Jeffrey R. Brown, Olivia S. Mitchell & James M. Poterba, The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program, RISK ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM 321, 321–322 (John Y. Campbell & Martin Feldstein, eds., 2001) (“[T]he expected present value of annuity payouts is typically below the purchase price of the annuity . . . .”); James M. Poterba & Mark Warshawsky, The
Basically, individuals are rarely able to purchase actuarially fair annuities in the retail annuities market. In that regard, however, it is worth emphasizing that, in effect, the Social Security system does allow workers to buy actuarially fair lifetime annuities merely by delaying retirement beyond age 62.\footnote{351}

Finally, it is worth noting that there are a few other problems with annuity markets in the United States. One problem has to do with the rates of return on annuities. While many analysts believe that stocks do better than bonds in the long run,\footnote{352} retail prices for annuities are tied to the relatively low yields that accompany bond rates.\footnote{353} That can make annuities relatively unattractive investments compared to stock-based mutual funds.\footnote{354}

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\footnote{351}See supra notes 24–27 and accompanying text.


\footnote{354}Certainly, the prices of fixed annuities are tied to bond prices. On the other hand, variable annuities typically allow the annuitant to invest in equities, at least during the accumulation phase. See, e.g., U.S. SEC. AND EXCH. COMM’N, \textit{Variable Annuities: What You Should Know}, supra note 141. For example, TIAA’s College Retirement Equity Funds (CREF) operates eight investment accounts that differ by objective: stocks, bonds, money market, and social choice. \textit{See Prospectus, College Retirement Equities Fund}, TIAA GLOBAL ASSET MANAGEMENT 26 (May 1, 2016). https://www.tiaa.org/public/pdf/cref_prospectus.pdf.
Another problem is that there is relatively little disclosure of the fees that insurance companies and agents charge for annuities.\footnote{Oakley, \textit{Retirement Security Risks: What Role can Annuities Play in Easing Risks in Public Pension Plans?}, supra note 1, at 16; Hueler et al., \textit{Public Policy and Consumer Disclosure for the Income Annuity Market}, supra note 338.} In the end that means that annuities are sold not bought, and the financial advisers and insurance agents selling annuities “can put their own financial interests ahead of the interests of the person they are advising.”\footnote{Memorandum from Office of Senator Elizabeth Warren, \textit{Villas, Castles, and Vacations: How Perks and Giveaways Create Conflicts of Interest in the Annuity Industry} 2 (Oct. 2015) (on file with Office of Senator Elizabeth Warren at http://www.warren.senate.gov/files/documents/2015-10-27_Senator_Warren_Report_on_Annuity_Industry.pdf).} In that regard, agents may be motivated to sell products that will generate bigger fees, perks, or even kickbacks.\footnote{\textit{Id.} at 2. The report notes that in addition to cash compensation to annuity sellers, companies “may offer “non-cash compensation” such as merchandise, gifts, marketing support, sponsorships, seminars, entertainment and travel expenses.” \textit{Id.} at 7 n.44 (quoting from a variable annuity contract prospectus of Lincoln National Life Insurance Company); \textit{see also} Lincoln National Life Insurance Company, Lincoln ChoicePlus AssuranceSM (B Share) Individual Variable Annuity Contracts Lincoln Life Variable Annuity Account N 135 (May 1, 2015) (unpublished manuscript), http://vpx.newriver.com/print.asp?clientid=lfgvpx&fundid=53422E439&doctype=pros.} The U.S. Department of Labor’s new fiduciary conflict-of-interest rule should help improve retail annuity prices, at least with respect to the sale of annuities to pension plan participants and IRA holders.\footnote{\textit{See supra} notes 90–91 and accompanying text.}

D. THE DEMOGRAPHICS OF LIFE EXPECTANCY

While lifetime pensions and annuities offer a great way to protect against longevity risk, annuities may be more valuable for some demographic groups than others. In that regard, life expectancy varies with such demographic factors as gender, income, educational level, and race and Hispanic origin.\footnote{\textit{See, e.g., National Center for Health Statistics: Life Expectancy}, CTR. FOR DISEASE CONTROL, http://www.cdc.gov/nchs/fastats/life-expectancy.htm (last visited Apr. 27, 2016) (various sources of data related to life expectancy); Forman, \textit{Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products}, supra note 161, at 384–85 and sources cited therein.} Indeed, as already mentioned, women tend to live longer than men,\footnote{\textit{See supra} note 2 and accompanying text.} and because of that, insurance companies tend to make smaller
lifetime annuity payments to women than to same-age men, although pension plans are not permitted to discriminate in that way. It is also well established that people with higher incomes tend to live longer than people with lower incomes. Also, healthy individuals tend to live longer than unhealthy individuals. All in all, policymakers need to bear in mind that some policies to encourage greater annuitization might have undesirable distributional consequences.

E. WHAT CAN WE LEARN FROM OTHER COUNTRIES?

The demand for and supply of lifetime annuities are consistently low in most of the world, although there are a few notable exceptions. The gold

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361 See supra notes 144–147 and accompanying text.
362 See supra note 106 and accompanying text.

364 For example, mortality tables show that healthy individuals have lower death probabilities than the general population. See, e.g., Soc’y of Actuaries, RP-2014 Rates; Total Dataset, supra note 219 (comparing death probabilities at various ages for employees, healthy annuitants, and disabled retirees). An individual’s death probability is her probability of dying within one year. See, e.g., SOC. SEC. ADMIN., Period Life Table, 2013, supra note 132.

365 In that regard, for example, life expectancy differences reduce the progressivity of the Social Security system. U.S. GOV’T ACCOUNTABILITY OFF., GAO-16-354, RETIREMENT SECURITY: SHORTER LIFE EXPECTANCY REDUCES PROJECTED LIFETIME BENEFITS FOR LOWER EARNERS, supra note 363, at 33–35.

366 See, e.g., Holzmann, Addressing Longevity Risk through Private Annuities: Issues and Options, supra note 338, at 1; Çebi, Can Annuities Enhance Retirement
standard is probably the Netherlands, where benefits from occupational pensions must be paid out in the form of an inflation-indexed annuity to qualify for tax benefits.\textsuperscript{367}

In many countries, however, participants can choose among lump sum distributions, phased withdrawals, and annuities, just as they often can in the United States. Experiences vary, but there are at least a few countries where participants generally select annuitization. For example, in Switzerland, around 80 percent of retirement savings accumulations are converted to lifetime annuities;\textsuperscript{368} and, in Chile, 70 percent of retirees choose lifetime annuitization of their public pension benefits over the phased-withdrawal alternative.\textsuperscript{369} On the other hand, annuitization in Australia is extremely rare.\textsuperscript{370} For example, in 2012, half of those who accessed their

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\textsuperscript{369} Holzmann, Addressing Longevity Risk through Private Annuities: Issues and Options, supra note 338, at 2; see also Ruiz & Mitchell, Pension Payouts in Chile: Past, Present, and Future Prospects, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY, supra note 142, at 106.

\end{footnotesize}
Superannuation Funds took lump sums, and 98 percent of the rest chose phased withdrawal over an annuity. The United Kingdom used to have high levels of annuitization, but it recently moved away from requiring retirees to purchase annuities, and even more recently, it gave existing annuity holders more freedom to sell their existing annuity contracts.

When coupled with the shift towards more lump sum distributions that we see in the United States, it seems that the international trend favors giving individuals more choices about how to manage their retirement.

Longevity Risk: Making Retirement Income Last a Lifetime, supra note 1, at 13–16.


savings, even if those choices result in less annuitization. Still, there is a lot that the United States can learn from other countries about how to help Americans get secure streams of lifetime income.\footnote{See, e.g., U.S. Gov’t Accountability Off., GAO-14-9, 401(k) Plans: Other Countries’ Experiences Offer Lessons in Policies and Oversight of Spend-down Options (Nov. 2013), http://www.gao.gov/assets/660/659169.pdf.} For example, the United States can probably learn from the various strategies that other countries use to increase participants’ knowledge and understanding of their spend-down options.\footnote{Id. at 24–32.} Some countries also make it harder for financial advisers to charge high commissions or offer inappropriate investment advice.\footnote{Id. at 34.}

Many countries also use incentives and withdrawal rules to help encourage annuitization.\footnote{Id. at 32–33, 35–37.} For example, in Switzerland, some plans use annuities as the default form of distribution, although participants can opt out.\footnote{Id. at 32.} Several countries require participants to meet certain minimum-retirement-income requirements if they want to withdraw all or part of their defined contribution plan assets as a lump sum.\footnote{Id. at 35.} Also, while plan sponsors in the United States have a fiduciary obligation to assess the financial stability of the insurance companies that sell annuities to the plans, plan sponsors in many countries have no such obligation.\footnote{Id. at 37–39.} Instead, plan sponsors in those countries can simply rely on insurance regulators and industry standards to oversee and monitor annuity providers.\footnote{Id.}

All in all, the international trend seems to be to give participants access to multiple spend-down options. At the same time, however, many countries are trying to find strategies to increase participants’ knowledge and understanding of annuity options, and they are also using withdrawal rules and limits on lump sum distributions to encourage participants to select those annuity options.

F. CHALLENGES TO ANNUITIZATION IN THE UNITED STATES

There are a number of cultural and economic challenges to increasing annuitization in the United States. In particular, as Part II.F above showed, many Americans have simply not saved enough in their retirement
plans or otherwise to make annuitization practical. Americans also have a woefully low level of financial literacy, and that limited financial literacy makes it hard for them to conduct meaningful retirement planning.\textsuperscript{382} Annuities are particular hard for individuals to understand and appreciate.\textsuperscript{383} For example, individuals often underestimate their life expectancies and overvalue the modest lump sums that they have accumulated.\textsuperscript{384}

\section{V. OPTIONS FOR REFORM}

This Part considers a variety of possible legislative and regulatory changes that could encourage greater annuitization of retirement savings.

\subsection{A. INCREASE AND PRESERVE RETIREMENT SAVINGS}

1. Encourage Workers to Save More for Retirement

At the outset, government policies could be designed to encourage workers to save more for retirement.\textsuperscript{385} If workers saved more during their

\begin{itemize}
  \item \textsuperscript{384} See, e.g., Soc’y of Actuaries, \textit{Key Findings and Issues: Longevity: 2011 Risks and Process of Retirement Survey Report} 4, 9 (June 2012), https://www.soa.org/research/research-projects/pension/research-post-retirement-needs-and-risks.aspx (finding that more than half of survey respondents underestimated population longevity); Rafaloff, \textit{supra} note 274 (noting that “participants tend to underestimate future income needs and overestimate the wealth effect a lump sum offer conveys”).
  \item \textsuperscript{385} U.S. GOV’T ACCOUNTABILITY OFF., \textit{GAO-16-408, Retirement Security: Low Defined Contribution Savings May Pose Challenges}, \textit{supra} note 190, at 26–42 (discussing a variety of individual and employer decisions that could substantially raise defined contribution plan savings rates, especially for low-income workers).
\end{itemize}
careers, they would have larger nest eggs at retirement and a greater ability
to buy annuities and other lifetime income products. Perhaps the best way to
increase retirement savings would be for the United States to adopt a
mandatory universal pension system like Australia, Singapore, and Chile
have done. A recent proposal would require employees without a pension
plan to contribute 3 percent of pay to new guaranteed retirement accounts
that would provide lifetime annuities.387

A less intrusive federal mandate would be to require employers
without plans to at least offer automatic payroll-deduction IRAs to their
employees.388 The United Kingdom’s new National Employment Savings

386 See, e.g., U.S. GOV’T ACCOUNTABILITY OFF., GAO-09-642, PRIVATE
PENSIONS: ALTERNATIVE APPROACHES COULD ADDRESS RETIREMENT RISKS FACED
new.items/d09642.pdf; TERESA GHILARDUCCI, WHEN I’M SIXTY-FOUR: THE PLOT
AGAINST PENSIONS AND THE PLAN TO SAVE THEM 260–92 (2008); Forman &
Mackenzie, Optimal Rules for Defined Contribution Plans: What Can We Learn
from the U.S. and Australian Pension Systems?, supra note 371, at 625; Jonathan
Barry Forman, Should We Replace the Current Pension System with a Universal
Pension System?, 16(2) J. PENSION BENEFITS 48 (2009); Jonathan Barry Forman &
Adam Carasso, Tax Considerations in a Universal Pension System, URBAN-
BROOKINGS TAX POL’Y CTR. (Dec. 20, 2007), http://www.urban.org/
publications/411593.html.

387 See, e.g., GHILARDUCCI, WHEN I’M SIXTY-FOUR: THE PLOT AGAINST
PENSIONS AND THE PLAN TO SAVE THEM, supra note 386; Teresa Ghilarducci &
Hamilton E. James, Opinion, A Smarter Plan to Make Retirement Savings Last, N.Y.
TIMES (Jan. 2, 2016), http://www.nytimes.com/2016/01/02/opinion/a-smarterplan-
to-make-retirement-savings-last.html?_r=0.

388 U.S. DEP’T OF THE TREASURY, General Explanations of the Administration’s
GOV’T ACCOUNTABILITY OFF., GAO-13-699, AUTOMATIC IRAS: LOWER-EARNING
HOUSEHOLDS COULD REALIZE INCREASES IN RETIREMENT INCOME (2013),
President’s 2013 Budget Would Enable Almost All Americans to Save for
Retirement, BROOKINGS (Feb. 15, 2012), http://www.brookings.edu/
opinions/2012/0215_budget_retirement_gale_john.aspx; J. Mark Iwry & David C.
John, Pursuing Universal Retirement Security Through Automatic IRAs,
BROOKINGS (July 1, 2009), https://www.brookings.edu/research/pursuing-
universal-retirement-security-through-automatic-iras-2/; Benjamin H. Harris &
Rachel M. Johnson, Economic Effects of Automatic Enrollment in Individual
Retirement Accounts, AARP PUB. POL’Y INST. (Research Report No. 2012-04,
2012), http://www.aarp.org/content/dam/aarp/research/public_policy_institute/
econ_sec/2012/Economic-Effects-of-Auto-IRA-Research-Report-AARP-ppi-con-
Trust (NEST) program is an example of this type of mandate. Pertinent here, the Obama Administration recently rolled out no-fee retirement savings accounts known as myRAs, short for My Retirement Account. A number of state governments in the United States are also considering requiring employers to at least offer pension plans to their uncovered workers. In that regard, the U.S. Department of Labor recently issued guidance that will make it easier for state governments to set up state-managed retirement plans for private-sector workers. In general, automatically enrolling workers


into these types of individual retirement savings accounts should achieve higher levels of participation. Automatic enrollment and similar behavioral economics nudges are not likely to solve the problem of inadequate retirement savings, but they are better than nothing.

There are also a variety of other proposals to expand the current voluntary pension system. For example, both Congress and the Obama Administration recommended amending ERISA to permit unaffiliated employers to join multiple-employer plans (MEPs). The Obama Administration also recommended expanding to expand coverage to allow long-term, part-time workers to participate in existing retirement plans. Under the proposal, employees who have worked at least 500 hours a year for three years for an employer with a 401(k) plan would be allowed to contribute to the plan.

The Obama Administration also recommended tripling the retirement plan start-up tax credit for small businesses—from the current maximum of $500 per year for three years to a maximum of $1500 per year for four years. Also, many believe that making the $1000 retirement saver’s tax credit refundable would help encourage low-income workers to save for retirement. Finally, the U.S. Government Accountability Office

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394 Id.


397 U.S. DEP’T OF THE TREASURY, General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals, supra note 388, at 140.

398 Id. at 136–37.

estimates that the elimination of pension eligibility and vesting waiting-periods would increase retirement savings by 10 percent overall, and by 15 percent for low-income workers.400

2. Help Participants Get Better Returns on Their Retirement Savings

In addition to getting workers to save more, government policies could encourage workers to do a better job with their investments. In that regard, the qualified default investment alternatives (QDIA) regulations have already helped move millions of participants away from low-yield, stable-value bond funds and towards better-diversified investments like target-date funds.401 The U.S. Department of Labor could clarify those QDIA regulations402 and also make it easier for plan sponsors to include annuities in their line-up of QDIA investment alternatives.403

The government could also do a better job of regulating the fees and expenses associated with retirement plans. In that regard, high fees can significantly reduce the size of retirement nest eggs.404 The U.S. Department of Labor’s new fiduciary conflict-of-interest rule should help.405 Managing retirement savings is a challenging task,406 and, as a result, many Americans

401 See supra notes 254–261 and accompanying text.
405 See supra notes 90–91 and accompanying text.
406 For example, pension plan participants need to decide whether to keep their money in the retirement plan, roll it over to an IRA, or take a lump sum distribution. Moreover, participants and former participants face a dizzying array of investment alternatives, including savings accounts, money market accounts, mutual funds, exchange-traded funds, individual stocks and bonds, and annuities. See e.g., Sally Herigstad, 6 Surprising IRA Investment Option, BANKRATE.COM,
seek investment advice from financial advisers. Often, however, the compensation that those financial advisers receive can vary depending on the investment products that the savers choose. That opened the door to conflicted advice that could put the rewards for the adviser ahead of the best interests of the savers. That conflicted advice can easily result in lower investment returns (net of fees). For example, a recent study by President Barrack Obama’s Council of Economic Advisors estimated that conflicted advice led to returns that are about one percentage point lower each year, and that, over a 30-year retirement, a retiree receiving such conflicted advice would lose an estimated 12 percent of her savings. Eventually, the new fiduciary conflict-of-interest rule should result in better advice at lower costs for pension plan participants and IRA holders, and that should translate into higher returns on their retirement savings.

Another way to help retirees get better returns on their retirement savings would be to encourage retirees to keep their savings in their relatively low-cost pension plans, as opposed to rolling their balances over into relatively higher-cost IRAs. Because there are economies of scale, pension plans tend to have much lower fees per participant than IRAs. Unfortunately, the vast majority of retirees move their defined-contribution plan savings to IRAs soon after they retire. For example, according to a recent Vanguard study, after five years less than 20 percent of participants


See, e.g., Memorandum from Office of Senator Elizabeth Warren, supra note 356.


Id. at 3. Given that some $1.7 trillion of IRA assets are invested in products that generate payments to financial advisers that generate conflicts of interest, the Council of Economic Advisers estimated that conflicted advice cost those savers about $17 billion a year. Id. at 3.

See supra notes 90–91 and accompanying text.

remained in their defined contribution plans. Better financial education could help encourage participants to keep their savings in those low-cost pension plans, and plan sponsors could also be encouraged to make it easier for participants to take partial distributions as needed, rather than lump sum distributions. Pertinent here, the 2015 ERISA Advisory Council made suggestions for plan sponsor education and a model notice that employers could use to encourage plan participants to keep their retirement savings in their pension plans rather than rolling their retirement savings into IRAs or taking lump sum distributions.

3. Encourage Workers to Work Longer

The government could also encourage workers to remain in the workforce longer. Working longer increases retirement savings and reduces the number of years that retirement savings need to cover, thereby increasing annual income when workers actually retire. For example, because Social Security provides actuarial increases in benefits to those who

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414 Id.
delay taking their benefits, the government could encourage people to delay taking their benefits until they reach their full retirement age or, better still, until age 70.

For that matter, the government could increase all of the statutory ages associated with retirement. For example, the 10 percent early distribution penalty on premature withdrawals applies only to distributions made before an individual reaches age 59½ and the early retirement age for Social Security is age 62. It could make sense to increase both early retirement ages to 65. It could also make sense to increase both the normal retirement age for Social Security (currently age 66 but gradually increasing to age 67) and the normal retirement age for pensions (typically age 65) to age 70. Finally, it could make sense to increase both the delayed retirement age for Social Security (currently age 70) and the required minimum distribution age for pensions (age 70½) to age 75 or beyond. In passing, however, policymakers need to bear in mind that some policies to raise retirement ages may have undesirable distributional consequences.

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418 See supra notes 24–27 and accompanying text.
420 See supra note 100 and accompanying text.
421 See supra note 16 and accompanying text.
422 See supra note 13 and accompanying text.
424 See supra note 25 and accompanying text.
425 See supra note 101 and accompanying text.
426 See also Richard L. Kaplan, Reforming the Taxation of Retirement Income, 32 VA. TAX REV. 327, 357 (2012); Jacob A. Mortenson, Heidi R. Schramm & Andrew Whitten, The Effect of Required Minimum Distribution Rules on Withdrawals from Traditional Individual Retirement Accounts (May 6, 2016), http://ssrn.com/abstract=2764435 (finding that 52 percent of IRA owners subject to the required minimum distribution rules would take an IRA distribution less than their required minimum if they were unconstrained).
427 See supra Part IV.D. See also Anne L. Alstott, A New Deal for Old Age 95–98 (2016) (suggesting that retirement age could be linked to lifetime income in a way that favors those workers with relatively lower lifetime earnings over those with relatively higher lifetime earnings); Henry Aaron, Recent Social Security blogs—some corrections, BROOKINGS (Apr. 15, 2016), http://www.brookings.edu/research/opinions/2016/04/15-recent-social-security-blogs-some-corrections-aaron (explaining how raising the full benefit age for Social Security is simply an across-
The federal government could also amend the required minimum distribution rules to make it easier to use retirement savings to buy deferred income annuities. In that regard, new regulations from the IRS have already eased the required minimum distribution rules to allow plan participants to spend up to $125,000 on deferred income annuities that are qualifying longevity annuity contracts (QLACs). Also, the Obama Administration recently called for legislation that would completely exempt an individual from the required minimum distribution rules if her tax-favored retirement plan accumulations do not exceed $100,000. All in all, the minimum distribution rules could be reformed to prioritize lifetime income provision over Treasury revenue-collection.

4. Preserve Benefits until Retirement

Government policies could also be designed to get workers to preserve their retirement savings until retirement, for example, by discouraging premature pension withdrawals and loans. While defined

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429 See infra notes 158–160 and accompanying text.


432 See, e.g., Forman & Mackenzie, Optimal Rules for Defined Contribution Plans: What Can We Learn from the U.S. and Australian Pension Systems?, supra note 371, at 650; Orlova et al., supra note 333, at 3; Richard L. Kaplan, Retirement
benefit plans typically provide lifetime annuities for retirees and their spouses, defined contribution plans are leaky: they often allow participants to withdraw all or a portion of their individual accounts, and many plans allow participants to borrow against their accounts. All in all, a significant portion of these premature distributions and loans are dissipated before retirement. Accordingly, it could make sense to further limit or even prohibit premature distributions and loans from defined contribution plans and IRAs. Also, the process for rolling over defined contribution balances can be cumbersome and could be simplified.

Also, plan sponsors who make annuity investments available within a plan do not always have good options to remove the annuity investment option from the plan when it is no longer suitable (which can happen, for example, when the plan changes its investment offerings or its record keeper). The Obama Administration recently recommended legislation that would allow plan participants to roll over any unauthorized lifetime

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433 See supra notes 236–241 (distributions), 57 (hardship distributions), and 56 (loans) and accompanying text.

434 See, e.g., Lucas, Plug the Drain: 401(k) Leakage and the Impact on Retirement, supra note 226; Copeland, Lump-Sum Distributions at Job Change, supra note 227; Hurd & Panis, The Choice to Cash Out, Maintain, or Annuitize Pension Rights upon Job Change or Retirement, supra note 59.


income investments to an IRA or other retirement plan—and so preserve these assets within the tax-favored retirement system.\textsuperscript{437}

5. Revise the Rules that Are Used to Calculate Lump Sum Distributions

The Treasury and the IRS could also revise the rules that are used to calculate lump sum distributions. As we have seen, when a plan sponsor offers to replace a lifetime pension benefit with a lump sum, the minimum lump sum that is offered must be an amount that is actuarially equivalent to the promised lifetime pension benefit.\textsuperscript{438} Basically, that means that the minimum lump sum must have a value equal to the present value of the participant’s lifetime stream of pension benefits. Unfortunately, the applicable regulations permit the use of that actuarially-equivalent lump sum amount even though that amount is almost invariably less valuable than the promised lifetime pension benefit. In fact, that minimum lump sum amount would almost never be sufficient to buy an insurance annuity as generous as the promised lifetime pension benefit. As Part IV.C above showed, the typical retail lifetime annuity has a 12 percent “load” factor built in, and the payouts from actuarially fair annuities would be around 15 percent higher than what can actually be purchased in current retail annuity markets. Similarly, in its recent study of lump sum risk transfers, the U.S. Government Accountability Office estimated that if a 65-year-old female participant were to accept a lump sum offer and then use that lump sum to purchase a retail annuity, her monthly annuity benefit would be 24 percent smaller than her lifetime pension benefit would have been (also estimating a 17 percent reduction for 65-year-old males).\textsuperscript{439}


\textsuperscript{438} See supra notes 211–220 and accompanying text.

In essence, in making a lump sum distribution, the plan sponsor shifts risk to the participant but does not fully compensate her for taking on that risk. The plan sponsor saves money, but it is generally a bad economic deal for the participant. Arguably, the right economic answer is that the plan sponsor should pay a premium to participants who take lump sum distributions. For example, instead of computing the lump sum as an amount equal to 100 percent of the actuarial present value of the participant’s lifetime pension benefit, perhaps, the plan sponsor should have to pay a premium of, say, 15 percent on top of that present value; that is, the plan sponsor could be required to pay a lump sum distribution equal to 115 percent of the present value of the participant’s lifetime pension benefit.

At bottom, in the typical lump sum distribution offer, the interests of plan sponsors and participants are in direct conflict, and that raises some interesting issues. In our voluntary pension system, plan sponsors are relatively free to design pension plans to their liking. That is the nature of the settlor function. On the other hand, when a plan sponsor administers its plan it acts as a fiduciary and so must operate in the best interest of the participants (and beneficiaries). In short, a plan sponsor’s decision to offer lump sum distributions, as a matter of course—or as part of a pension risk transfer transaction, is a matter of plan design that is viewed as a settlor function rather than a fiduciary function, but when the plan sponsor implements lump sum distributions, it acts as a fiduciary.

The first set of issues relates to the plan sponsor’s ability to offer lump sum distributions. For example, as Part III.E.3.b above showed, amending a plan to offer participants a new lump sum benefit is pretty clearly a settlor function (not a fiduciary function). Accordingly, the plan sponsor is generally free to amend the plan to offer the lump sum distributions and is generally free to define the terms of that offer. Within certain regulatory limits the interest rate and the mortality table to be used in computing the lump sum will be identified in the plan amendment. As these selections involve the settlor function, a plan sponsor can select permissible interest

18 (showing estimates that if a 65-year-old male participant were to accept a lump sum offer and then use that lump sum to purchase a retail annuity, his monthly annuity benefit would be around 10 percent smaller than his lifetime pension benefit would have been [an $897 per month annuity versus a $1000 per month pension] and also estimating a 14 percent reduction for 65-year-old female [an $861 per month annuity versus a $1000 per month pension]).

440 See supra notes 294–295 and accompanying text.
442 See supra notes 294–295 and accompanying text.
rates and mortality tables that are advantageous to it. Under the current rules, for example, a plan sponsor can gain a financial advantage for itself by selecting a so-called “lookback” interest rate from up to 17 months earlier—when that interest rate is higher (and so results in lower lump sums) than the rate that prevails at the time the lump sum offer is made.\textsuperscript{443} Similarly, until new mortality table regulations come into effect for 2017 or later,\textsuperscript{444} a plan sponsor can gain a financial advantage for itself by selecting the currently-required mortality table with its relatively shorter life expectancies (that result in fewer months of pension benefits and so lower lump sums).\textsuperscript{445}

The second set of issues relates to the plan sponsor’s implementation of lump sum distributions. Here, the plan sponsor must act as a fiduciary. That makes it a real challenge for the plan sponsor, as its interests are economically adverse to the interests of its participants: the plan sponsor typically expects to save money by encouraging its plan participants to take lump sums that are almost invariably less valuable than the participants’ lifetime pension benefits.

The author believes that a plan sponsor breaches its fiduciary duties to its participants if it downplays the very real reductions in value that occur when participants elect to take lump sum distributions rather than retaining their lifetime pension benefits. Acting as a fiduciary, the plan sponsor should be fully forthcoming with all the information that the participants (and beneficiaries) need to make informed decisions. It will never be enough for a plan sponsor to offer an unblemished picture of the pension risk transfer options: the plan sponsor should reveal the naked truth about lump sums, warts and all. The government has ample authority to require that plan sponsors make full disclosures about how the proffered lump sums truly compare with the participants’ lifetime pension benefits.\textsuperscript{446}

All in all, the author believes that the Treasury and the IRS should revise the relative value regulations that are used to compute lump sums.\textsuperscript{447} Plan sponsors could be required to use the most up-to-date mortality tables for lump sum calculations.\textsuperscript{448} Plan sponsors could also be required to take

\textsuperscript{443} See supra notes 298–299 and accompanying text.
\textsuperscript{444} See supra notes 218–220 and accompanying text.
\textsuperscript{445} As the I.R.C. § 411(d)(6) anti-cutback rule protects a participant’s accrued benefits, a plan sponsor can never amend its plan to offer a lump sum alternative that actually cuts benefits.
\textsuperscript{446} See, e.g., supra note 84 and accompanying text.
\textsuperscript{447} See also U.S. GOV’T ACCOUNTABILITY OFF., GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS, supra note 268, at 51.
\textsuperscript{448} See, e.g., Noel Abkemeier, et al., Risky Business: Living Longer Without
into account the value of any subsidies or other supplements provided by the plan. For example, if the plan offers an enhanced early retirement subsidy, revised relative value regulations could require that that subsidy be taken into account when computing the amount of a lump sum distribution.449 Finally, the Treasury and the IRS might consider requiring plan sponsors to pay a premium (say 15 percent) on top of the actuarially-determined present value (although legislation might be needed before this requirement could be imposed).

At the very least, the relative value notices required by the IRS and any notices of plan benefits required by the PBGC or the U.S. Department of Labor could make plan sponsors clearly disclose the very real reductions in value that occur when a participant elects to take a lump sum in lieu of retaining her lifetime pension benefit. While the present actuarial valuation rules permit plan sponsors to offer lump sums that are based on out-of-date interest rates and mortality tables, the applicable notices could require the prominent disclosure of the “right” interest rates and mortality tables. The notices could also explain how hard it is to invest a lump sum to provide equivalent lifetime income and how difficult it is to use a lump sum to purchase a retail annuity that replicates the participants’ lifetime pension benefit. The model lump sum risk transfer notice recommended by the 2015 ERISA Advisory Council addresses these concerns, for example by noting that “[a]n annuity purchased in the insurance market will generally provide less income than your plan’s pension.”450

B. REFORM THE TAX TREATMENT OF ANNUITIES AND DEFERRED INCOME ANNUITIES

The current tax treatment of annuities has some features that encourage individuals to buy them and some features that do not. On the whole, the deferral of taxation on annuities until benefits are actually received is a very valuable tax benefit, especially when compared to, say, a regular bank account where the interest income is taxed on an annual basis


449 Id. at 6–7.

450 U.S. DEP’T OF LABOR, ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, Model Notices and Disclosures for Pension Risk Transfers, supra note 324, at 35.
at ordinary income tax rates.451 As Table 2 above showed, the exclusion of investment income on annuity and life insurance was listed as a $23.4 billion tax expenditure in the U.S. Government’s Fiscal Year 2017 Budget, and over the years, including this “inside buildup” in taxable income has been a common tax-reform proposal.452

In that regard, under a comprehensive income tax (i.e., a theoretically pure income tax), individuals would pay tax on the sum of the wages, interest, dividends, and other forms of economic income that they earn.453 Portions of the premiums paid for annuities are invested and earn interest, dividends, and other types of investment income. That investment income—the inside buildup—is generally not taxable until the annuitant begins receiving annuity distributions.454 Under a comprehensive income tax, investors would be taxed on those investment earnings annually, just like investors in bank accounts, taxable bonds, and mutual funds, and it could make sense to extend comprehensive income tax treatment to annuities (and life insurance) by taxing the inside buildup in those policies. According to


454 A similar deferral of tax occurs on investments in whole-life insurance policies. A whole-life insurance policy provides life insurance coverage throughout the insured’s whole life, as opposed to term-life insurance which provides coverage for a specified period. CONG. BUDGET OFF., supra note 452, at 126.
the Joint Committee on Taxation, including the investment income from annuities (and life insurance) in taxable income would have raised $24 billion in Fiscal Year 2015 and $210 billion over ten years.\(^\text{455}\)

Perhaps a better approach would be to continue the current exclusion for the inside buildup in annuities, but only for lifetime annuities. This approach—which was suggested by the President’s 2005 Advisory Panel on Federal Tax Reform—would continue to encourage annuities that provide lifetime income but discourage the use of annuities and variable annuities merely for tax avoidance.\(^\text{456}\)

The federal government might also consider other ways the tax system could be used to encourage investors and plan participants to select lifetime annuities and deferred income annuities. As explained in Part II.D.2.c above, current law allows a life annuitant to recover a portion of each annuity payment tax-free but only until she recovers her investment in the contract—typically, as she reaches her life expectancy; thereafter, each annuity payment received is fully taxable. The current rule provides some balance, as it typically allows annuitants who die before they recover their annuity investment to deduct the unrecovered portion in the year they die. Still, if the federal government wants to encourage individuals to buy lifetime annuities and deferred income annuities, it could consider allowing individuals to keep excluding a portion of each annuity payment from income even if they live beyond their life expectancy. After all, it certainly seems odd that taxes increase on those who “live too long.”\(^\text{457}\) Alternatively, or, perhaps, in addition to extending the exclusion ratio for more years, the federal government might also allow individuals to deduct any unrecovered annuity investments even if they die before the annuity starting date. After all, it seems strange that only those individuals who live past the annuity starting date are allowed to deduct their unrecovered annuity investments; and that rule almost certainly discourages the purchase of deferred income annuities.\(^\text{458}\) All in all, the benefits from changing these tax rules to better encourage the purchase of lifetime annuities and deferred income annuities

\(^{455}\) Cong. Budget Off., supra note 452, at 126. See also Table 2, supra (showing the Office of Management and Budget’s slightly different tax expenditure estimates: $23 billion in Fiscal Year 2017 and $371 billion over ten years).


\(^{457}\) See supra note 171 and accompanying text.

\(^{458}\) See supra notes 172–176 and accompanying text.
would probably outweigh the revenue losses that would result from those changes.

The federal government might even provide additional tax benefits for individuals who receive income from lifetime annuities and lifetime pensions, for example, by completely exempting lifetime income payments from income taxation or favoring them with a reduced tax rate.\footnote{See, e.g., Retirement Security Needs Lifetime Pay Act of 2009, H.R. 2748, 111th Cong. (2009) (a bill introduced by former Representative Earl Pomeroy [D-N.D.] to encourage guaranteed lifetime income payments by excluding from income a portion of such payments); Çebi, supra note 338, at 7; AM. ACAD. OF ACTUARIES, supra note 448, at 8.} In that regard, investments always involve choices, and tax rates can influence those choices. Under current law, annuity (and pension) income is subject to ordinary income tax rates of up to 39.6 percent, but capital gains and dividends are typically taxed at just 0, 15, or 20 percent.\footnote{See supra notes 120–121 and accompanying text.} Those preferential tax rates for capital gains and dividends can be very attractive, even to investors who would prefer the lifetime income that comes from investing in annuities (or pensions).\footnote{See, e.g., William J. Bernstein, A Limited Case for Variable Annuities, EFFICIENT FRONTIER, http://www.efficientfrontier.com/ef/701/annuity.htm (last visited July 27, 2016) (giving some numerical examples that show how investments in variable annuities compare with free-standing stock market investments over time).} Accordingly, as long as there are preferential tax rates for capital gains and dividends, it might make sense to extend those preferential tax rates to the income that comes from lifetime annuities and lifetime pensions. Policymakers could, of course, target the benefit towards less affluent retirees by limiting the preferential rates to, say, no more than $30,000 a year of annuity or pension income per retiree.

C. THE GOVERNMENT COULD MANDATE OR ENCOURAGE ANNUITIZATION

Since 2010, the IRS and the U.S. Department of Labor have made a concerted effort to promote lifetime income options for retirement plans.\footnote{See, e.g., U.S. DEP’T OF LABOR, Emp. Benefits Security Admin., Lifetime Income Options for Participants and Beneficiaries in Retirement Plans (2010), http://www.dol.gov/ebsa/regs/cmt-1210-AB33.html.} For example, in 2012, the Treasury and the IRS released a package of proposed regulations and rulings intended to make it easier for pension plans to offer partial annuities, longevity annuities, and other lifetime income
choices; and in 2014, the IRS promulgated final regulations that ease the minimum distribution requirements to allow plan participants to spend up to $125,000 on qualified longevity annuity contracts (QLACs). This subpart discusses a variety of other ways that the government could promote annuitization. In that regard, however, policymakers need to bear in mind that some policies to mandate or encourage annuitization might have undesirable distributional consequences.

1. The Government Could Mandate Annuitization

One approach would be for the government to mandate that retirees use at least a portion of their retirement savings to purchase annuities or similar lifetime income guarantees. Under this approach, participants in tax-favored plans and IRA holders could be required to annuitize at least a portion of their tax-favored retirement savings—unless they could show that they have adequate lifetime income streams from other sources.

2. The Government Could Require that Pension Plans Offer Annuities as an Investment and/or Distribution Option

Alternatively, the government might only want to encourage annuitization. For example, the government could require plan sponsors to include annuities or other lifetime income mechanisms in their investment options and/or in their distribution options. The government might also

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464 See supra notes 158–160 and accompanying text.

465 See supra Part IV.D. See also Webb, The United States Longevity Insurance Market, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY, supra note 142, at 75–76 (noting that mandating annuitization could adversely affect a meaningful number of households).


467 See, e.g., U.S. GOV’T ACCOUNTABILITY OFF., supra note 51, at 38–39; Jeffrey R. Brown, Understanding the Role of Annuities in Retirement Planning,
encourage pension plans to offer beneficiaries more flexibility, for example, by offering partial annuitization options and not just all-or-nothing annuitization choices.\textsuperscript{468} The government might even require plans to default participants into annuities or trial annuities, unless participants affirmatively elect otherwise.\textsuperscript{469}


\textsuperscript{468} See, e.g., Beshears et al., supra note 383, at 17 (finding that “most consumers prefer partial annuitization of their retirement nest egg over either 0% or 100% annuitization”); INTERNAL REVENUE SERV., \textit{Modifications to Minimum Present Value Requirements for Partial Annuity Distribution Options Under Defined Benefit Pension Plans} 81 Fed. Reg. 62,359 (Sept. 9, 2016) (recently issued regulations that make it easier for defined benefit plans to offer both a partial lump sum and a partial annuity).

3. The Government Could Sell or Guarantee Annuities

The federal government could even get into the market of selling annuities. As already mentioned, the Social Security system implicitly allows workers to buy actuarially fair lifetime annuities merely by delaying retirement beyond age 62, but the government might also let individuals and couples buy a limited amount of explicit inflation-adjusted lifetime annuities—perhaps enough to keep them out of poverty throughout their retirement years. Alternatively, the federal government could guarantee annuities sold by private companies.

4. The Government Could Make It Easier for Plan Sponsors to Offer Annuities and Deferred Income Annuities

As Parts III.B.2 and III.C.2 above explained, plan sponsors that offer annuities have fiduciary responsibilities with respect to the selection and monitoring of annuity providers. Plan sponsors can avoid those fiduciary duties if they instead only make lump sum distributions and leave it to the terminating employees to buy their own annuities directly (in after-tax dollars) or, alternatively, indirectly through a rollover IRA (using pre-tax dollars). The U.S. Department of Labor has a long way to go in overcoming plan sponsor concerns about offering in-plan annuities without fear of breaching their fiduciary duties. In general, it would be good to reduce these regulatory barriers.

470 See, e.g., Forman supra note 161 at 414–417 and sources cited therein; ELLIS ET AL., supra note 199, at 119.
471 See supra notes 24–27 and accompanying text.
472 In 2016, the poverty level for a single individual was $11,880, and the poverty level for a married couple was $16,020. U.S. DEP’T OF HEALTH AND HUM. SERVS, OFF. OF THE ASSISTANT SEC’Y FOR PLANNING AND EVALUATION, POVERTY GUIDELINES (2016), https://aspe.hhs.gov/poverty-guidelines.
473 See, e.g., supra note 235 and accompanying text.
474 See, e.g., Utkus, supra note 262 (“Concerns about barriers to in-plan annuities have led the Department of Labor to clarify its rules for in-plan annuity selection. So far, the rule clarification hasn’t changed employer sentiment.”); McGee, supra note 60, at 13; Brown, supra note 403; AM. ACAD. OF ACTUARIES, supra note 448, at 5–6; VOYA, Legislative Update (June 2015), https://investments.voya.com/idc/groups/public/documents/retirement/132351.pdf; Steve Vernon, Foundations in Research for Regulatory Guidelines on the Design &
In particular, it might make sense to let plan sponsors rely on insurance regulators and industry standards to oversee and monitor annuity providers. That is the way it works in many other countries, and it could probably work in the United States, as well. For example, the U.S. Department of Labor’s Employee Benefits Security Administration (or alternatively, the U.S. Department of Treasury’s Federal Insurance Office) could post a list of approved annuities and annuity providers that plan sponsors could use. Alternatively, the U.S. Department of Labor could at least host a website that would serve as a clearing house of information about annuity providers and annuity products.

Also, better guidance on the process of selecting qualifying longevity annuity contracts (QLACs) and other deferred income annuities would increase their utilization. For that matter, it could make sense for the government to “jump-start” the market for deferred income annuities by offering them in the federal government’s Thrift Savings defined contribution plan.

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476 Insurers interested in having their annuity products on the “qualified” list could be required to formally apply for listing and meet certain solvency and consumer-protection standards. See also Abraham & Harris, supra note 153, at 22 (suggesting that the government find a way to “certify financial products—including longevity annuities—that meet established standards for reliability, cost, and quality”).

477 Toth & Giller, supra note 475, at 29–31.


479 Abraham & Harris, supra note 153, at 22.
5. The Government Could Promote Education about Lifetime Income Options

The government could promote lifetime income options both through its own educational efforts and also by making it easier for plan sponsors to provide financial education and retirement planning advice.

a. Government Efforts

At the very least, the government could promote better financial education about annuities and other lifetime income options. In that regard, one way to encourage retirees to choose annuities and other forms of lifetime income is to promote financial education that frames the retirement decision in terms of lifetime consumption rather than in investment-oriented language that simply encourages individuals to accumulate large lump sums.

Information about replacement rates would help workers better understand how to convert their account balances into lifetime income streams. The U.S. Government Accountability Office recommends that the U.S. Department of Labor retirement planning tools should build in more flexibility so that users can better understand how account balances translate into replacement rates that meet their personal needs. The U.S. Department of Labor already hosts a Lifetime Income Calculator that can be used to estimate monthly pension benefits for a typical retiree. For

Çebi, supra note 338, at 7.


U.S. GOVERNMENT ACCOUNTABILITY OFF., GAO-16-242, RETIREMENT SECURITY: BETTER INFORMATION ON INCOME REPLACEMENT RATES NEEDED TO HELP WORKERS PLAN FOR RETIREMENT, supra note 382.

Id. at 38.

example, for a 65-year-old participant retiring on July 22, 2016 with a current account balance of $100,000, the calculator projects that she can expect to receive $486 a month for the rest of her life ($5832 per year = 12 × $486 per month).\footnote{\textit{U.S. DEP’T OF LAB., EMP. BENEFITS SEC. ADMIN, supra note 484, click on “Go to the Calculator”; enter Retirement Age: 65; Current Account Balance: $100,000; Current Annual Contribution: $0; Years to Retirement: 0; Statement Date: enter today’s date; and click on “Calculate,” and get Lifetime Income/Month for Participant With No Survivor Benefit: $486. The results also show the $439 per month that the participant (and spouse) would receive under a joint and survivor annuity (and the $220 [50 percent] that would be paid to the surviving spouse), assuming that the participant and the spouse are the same age. \textit{Id}}} According to the \textit{Advanced Annuity Calculator} at Immediateannuities.com, a 65-year-old man buying a $100,000 lifetime annuity on July 22, 2016 would receive $531 per month for the rest of his life ($6372 per year = 12 × $531 per month), while a 65-year-old woman would receive $498 per month for the rest of her life ($5976 per year = 12 × $498 per month).\footnote{\textit{Advanced Annuity Calculator, IMMEDIATEANNUITIES https://www.immediateannuities.com/annuity-calculators/ (last visited July 22, 2016) (Male: enter My Age Today: 65; My Gender: Male; State of Residence: DC; Income Start Date: Immediately; $ Investment: $100,000; click on “Calculate,” and get Estimated Monthly Income: $582; Female: enter My Age Today: 65; My Gender: Female; State of Residence: DC; Income Start Date: Immediately; $ Investment: $100,000;}}

\begin{itemize}
  \item ANPRM [Advance notice of proposed rulemaking] for estimating future contributions, investment earnings, and inflation:
    \begin{itemize}
      \item Contributions continue to Retirement Age at the Current Annual Contribution amount increased by 3 percent per year.
      \item Investment returns are 7 percent per year (nominal).
      \item An inflation rate of 3 percent per year is used for discounting the projected account balance to today’s dollars.
    \end{itemize}

In converting the account balances into lifetime income streams, the calculator uses the safe harbor annuity conversion assumptions described in the ANPRM:
    \begin{itemize}
      \item A rate of interest equal to the 10-year constant maturity Treasury securities rate for the first business day of the last month of the period to which the statement relates (equal to 1.63\% as of December 3, 2012 for statement periods ending December 31, 2012).
      \item The applicable mortality table under section 417(e)(3)(B) of the Internal Revenue Code in effect on the first day of the last month of the period to which the statement relates. This is a unisex table (i.e., the annuity values are the same for males and females).
      \item No insurance company load for expenses, profit, reserves, etc.
    \end{itemize}
In addition to the Lifetime Income Calculator, the U.S. Department of Labor could provide (or endorse) more extensive calculators that could be used by participants to evaluate the choice between lifetime pension benefits and lump sum distributions. Both present-value-of-an-annuity and principal-sum-to-annuity calculators could be hosted. Ideally, these calculators would allow participants to use a variety of assumptions about life expectancy and rates of return, rather than just the fixed assumptions in the current Lifetime Income Calculator.\(^{487}\)

The U.S. Department of Labor could also design (or endorse) an individualized Life Expectancy Calculator to help participants get a better idea how long they and their spouses can expect to live. To calculate life expectancy, these individualized calculators typically ask about an individual’s age, education, work, smoking habits, exercise regime, and family health.\(^{488}\) At the very least, the U.S. Department of Labor could link to the very simple life expectancy calculator that the Social Security Administration hosts on its website.\(^{489}\) The U.S. Department of Labor could also prominently display or link to individual and joint life expectancy tables.\(^{490}\) In addition to providing life expectancy tables for the average click on “Calculate,” and get Estimated Monthly Income: $531). The Advanced Annuity Calculator can also be used to find payments for couples. For example, when a 65-year-old male is coupled with a 65-year-old female, the results show that the 65-year-old couple would get a joint life annuity providing Estimated Monthly Income of $444 per month ($5328 per year = 12 × $444 per month). See also Should I Buy an Income Annuity?, CANNEX.COM, http://www.cannex.com/public/antcvp01.pdf (last visited Jan. 8, 2017); What is My Return with an Income Annuity? (IRR), CANNEX.COM, https://www.cannex.com/usa/english/tool_ irr_public.html (last visited Jan. 8, 2017).

\(^{487}\) See U.S. DEP’T OF LAB., EMP. BENEFITS SEC. ADMIN supra note 484.


population, it could make sense to provide life tables for individuals who are healthier than the average population.\footnote{Life and Last Survivor Annuities, Two Lives (Publication No. 939, 2013), http://www.irs.gov/pub/irs-pdf/p939.pdf; Treas. Reg. § 1.72-9 tbls. V & VI}{footnote mark}  

b. \textit{Plan Sponsors} 

Plan sponsors are not required to provide retirement planning advice, and concerns about fiduciary liability often keep them from doing so.\footnote{See \textit{Transamerica Center for Retirement Studies}, \textit{The Current State of Retirement: A Compendium of Findings About American Retirees} 48 (Apr. 2016), https://www.transamericacenter.org/docs/default-source/retirees-survey/tcrs2016_sr_retiree_compendium.pdf (survey showing that more than 60 percent of most recent employers did little or nothing to help pre-retirees transition into retirement).}{footnote mark} Even when employers provide financial education and retirement planning advice, they may not spend much effort explaining annuities and other lifetime income options.\footnote{For example, a recent survey of 406 large employers found that just 26.8\% of those who offered financial/retirement education said they discussed annuities with their employees and plan participants. \textit{Int’l Found. of Emp. Benefit Plans}, \textit{Financial Education for Today’s Workforce: 2016 Survey Results} 20 ex. 17 (2016), https://www.ifebp.org/pdf/financial-education-2016-survey-results.pdf.}{footnote mark} The costs of providing such retirement planning advice may also be a problem, particularly for smaller employees. Somehow, the government could make it easier for plan sponsors to provide such financial education and retirement planning advice. In that regard, the U.S. Department of Labor is already considering changes that would require that the periodic benefit statements provided to defined contribution plan participants about their account balances also show how those account balances would be expressed as estimated streams of payments.\footnote{U.S. DEP’T OF LAB., EMP. BENEFITS SEC. ADMIN., \textit{Fact Sheet: Lifetime Income Illustration} (May 7, 2013), http://www.dol.gov/ebsa/pdf/fsanprm.pdf; Pension Benefits Statements, 78 Fed. Reg. 26,727 (May 8, 2013) (to be codified at 29 C.F.R. pt. 2520), http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=26998 (Advance notice of proposed rulemaking issued under ERISA § 105, 29 U.S.C. § 1025 (2006)). \textit{See also} U.S. GOV’T ACCOUNTABILITY OFF., supra note 374, at 21–23.}{footnote mark}
D. IMPROVE ANNUITY REGULATION AND MARKETS

1. Strengthen the Regulation of Annuities

As already explained in Part III.A above, annuities are generally regulated under state insurance laws, and all states have state-based guaranty funds that provide at least $100,000 of protection for each annuitant in case the insurance company that sold the policy becomes insolvent. Unfortunately, the current state-by-state insurance regulatory system is antiquated, costly, and inefficient. One way to cut down on regulatory costs might be to allow insurance companies to avoid costly state-by-state regulation by instead electing an optional federal charter. Another approach would be to make the state-based guaranty funds that backstop annuities stronger. A more uniform standard, or even a federal guaranty fund, would be preferable to the current system. All in all, these kinds of improvements in annuity markets would make annuities more attractive to plan sponsors and to individual purchasers.

2. Allow Annuity Providers to Advertise Their State Guarantees

A related problem with retail annuities in the United States is that state laws generally prevent insurance companies from mentioning their state-based guarantees in their sales material. That, too, could be changed. The no-advertising rule seems to be designed to limit the moral hazard among insurance companies that might occur if insurance companies took greater investment risks because they could rely on the state-based insurance guarantees. While we should be concerned about the solvency of insurance companies, allowing insurance companies to advertise their state-based guarantees would make annuities more attractive to plan sponsors and to individual purchasers.

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496 Id. at 156–159 (citing numerous insurance industry association proposals).
497 Id. at 157–159.
498 Id. at 158 and sources cited in 158 n15.
499 AM. ACAD. OF ACTUARIES, supra note 448, at 5; Abraham & Harris, supra note 153, at 20 (also noting that Alabama and Michigan are two states that do not have a no-advertising rule).
500 AM. ACAD. OF ACTUARIES, supra note 448, at 5.
guarantees would increase consumer confidence in annuities and so encourage more individuals to buy them.\textsuperscript{501} Moreover, competitive pricing of annuities would also improve, as consumers would feel less need to pay higher premiums to buy annuities from insurance companies with higher financial rankings.\textsuperscript{502} In short, purchasers would get better prices for their annuities. In that regard, while the \textit{Annuity Shopper} reports that the average monthly benefit for a $100,000 immediate fixed annuity for a 65-year-old man in December 1, 2015 for a 65-year-old man was $545 per month ($6540 per year),\textsuperscript{503} policy quotes from the individual companies cited there ranged from $528 per month to $560 per month.\textsuperscript{504} Simple single-life annuities such as the one for a 65-year-old male are probably the most competitive annuity product offered by insurance companies, but there is even more price variation on some of the more complicated annuity products reported on in a typical issue of the \textit{Annuity Shopper}, and, no doubt, we would see even more price variation if we also reviewed the annuity prices charged by those insurance companies that are not included in the \textit{Annuity Shopper} surveys. As all similar annuities come with the same state-based guarantee, we should be concerned anytime a purchaser has to pay much more than it would cost to cover the cost of an actuarial fair annuity plus a small premium to cover an insurance company’s risks and profits.

3. Broaden the Range of Permissible Lifetime Income Products

In addition to promoting annuities, it could make sense to broaden the range of permissible lifetime income products. One approach is to develop more products that pool risk among participants, as opposed to products that necessitate high premiums to compensate insurance companies for their guarantees and profits. In that regard, for example, TIAA’s College Retirement Equities Fund (CREF) has been offering low-cost variable annuities that pool risk among participants for years.\textsuperscript{505} Participants choose

\textsuperscript{501} See, e.g., Beshears et al., \textit{supra} note 383, at 14.
\textsuperscript{502} See, e.g., MOSHE MILEVSKY, LIFE ANNUITIES: AN OPTIMAL PRODUCT FOR RETIREMENT INCOME 27–30 (The Research Foundation of CFA Institute, 2013), http://ssrn.com/abstract=2571379 (discussing the relationship between annuity pricing and insurance company credit rating).
\textsuperscript{503} See \textit{supra} note 144 and accompanying text.
\textsuperscript{504} Id.
\textsuperscript{505} Poterba & Warshawky, \textit{supra} note 350, at 191–198 (discussing the history and development of individual annuities offered by TIAA); Forman & Sabin, \textit{supra}
from various funds to invest in; and later on, they choose from among a
variety of distribution options, including one-life and two-life annuities.\textsuperscript{506}
When a retiree selects a lifetime annuity, the annuity payments depend on
both the investment experience of the chosen accounts and the mortality
experience of the other participants, but the way these annuities are designed,
the mortality risk falls on the annuitants and is not guaranteed by TIAA.\textsuperscript{507}

There are many other ideas for lifetime income products that could
share longevity risk among participants.\textsuperscript{508} For example, so-called “defined-
ambition plans”—like those in operation in the Netherlands—offer a way to share risk among plan participants.\textsuperscript{509} Also, elsewhere, the author has suggested we could pool risk among participants with so-called “tontine annuities”\textsuperscript{510} and “tontine pensions.”\textsuperscript{511} So-called “variable annuity pension plans” are another product that could help promote retirement income security.\textsuperscript{512} Another idea would be to modify ERISA to permit employers to offer longevity plans—supplemental defined benefit plans where participation begins at age 45 or later and benefits commence at age 75 or later.\textsuperscript{513}

E. OTHER IDEAS

At some point the government also needs to solve the underfunding problems of both Social Security and the PBGC.\textsuperscript{514}


\textsuperscript{510} See, e.g., Forman & Sabin, \textit{supra} note 126, at 790–801.

\textsuperscript{511} See, e.g., \textit{id.}, at 802–804.

\textsuperscript{512} Grant Camp, Kelly S. Coffing & Ladd E. Preppernau, \textit{Making the case for variable annuity pension plans (VAPPs), MILLMAN} (Oct. 7, 2014), http://us.milliman.com/basic-vapp-benefits/ (“A VAPP is a defined benefit (DB) pension plan where the benefits adjust each year based on the return of the plan’s assets, resulting in stable funding requirements.”).


\textsuperscript{514} \textit{AM. ACAD. OF ACTUARIES, supra} note 448, at 10–12.
VI. CONCLUSION

Pensions, annuities, and similar lifetime income products provide the best way to protect against longevity risk. Over the years, the responsibility for creating such secure retirement income streams has shifted from employers to individuals. This Article showed how changes in the U.S. laws and regulations governing pensions and annuities could help promote secure, lifetime income policies. More specifically, this Article showed how the laws governing annuities could be changed to make voluntary annuitization more attractive and how the laws regulating pensions could be changed to incentivize pension plan sponsors to offer more annuity options and to encourage employees to elect those options.