Holland & Hart

Brenda Berg

Partner
303.295.8029
Denver
brberg@hollandhart.com

Fewer Hurdles for Lifetime Income in Retirement Plans

Insight — February 14, 2012

With the decline in the number of defined benefit plans, fewer employees can rely on a guaranteed stream of retirement income outside of Social Security. Instead, most employees must figure out how to make their finite 401(k) balances last for the rest of their lives – a daunting task to say the least. Although employers are permitted to offer an annuity option investment with a guaranteed income stream in 401(k) plans, employers are often deterred by the regulatory and administrative hurdles involved in doing so. Now under the Treasury and Labor Departments' initiative to "give employees and employers more options for putting the 'pension' back in our private pension system," several pieces of guidance have been issued that move a few steps closer to clearing those hurdles.

The following challenges to offering lifetime income payments are addressed in the new guidance:

- Minimum distribution rules discourage longevity annuity contracts in defined contribution plans. A longevity annuity contract (longevity insurance) is a deferred annuity that begins at an advanced age (such as 80 or 85) after the participant retires, and then provides a guaranteed annual payment amount. A longevity annuity contract would hedge against longevity risk: the risk that the participant would run out of funds before dying.

  Currently, if a participant elects all or a portion of his or her account to be invested in a longevity annuity contract, the value of the longevity annuity contract must be included in the participant's account balance in determining the annual 401(a)(9) minimum required distribution amount. The 401(a)(9) minimum distribution rules under the Internal Revenue Code ("Code") require a certain portion of a participant's account balance to be distributed annually once the participant reaches the required distribution age, generally age 70½. If the participant has invested some of the account in a longevity annuity contract, there are no funds from the longevity annuity contract available to pay the minimum distribution, unless the contract allows an acceleration of payments, which generally costs more.

  New proposed Treasury regulations would amend regulations applicable to qualified plans such as 401(k) plans, 403(b) plans, governmental 457 plans, and non-Roth IRAs to provide that the value of "qualified longevity annuity contracts" (a new acronym, "QLAC") that satisfy certain requirements would be excluded from the account balance used to determine minimum distributions. Some of the requirements are that no more than 25% of the

participant's account balance, or $100,000 if less, can be invested in the QLACs, which must begin payments by age 85. This is in order to be consistent with the purpose of the 401(a)(9) rules, one of which is to limit accumulation of tax-deferred wealth. The proposed regulations also set forth disclosure and annual reporting requirements for QLACs.

These proposed rules cannot be relied on until published as final regulations.

- Requirements for calculating benefit options deter offering defined benefit plan payment options that are partial annuities and partial lump sums. Currently, if a defined benefit plan has a payment option for which a participant can elect payment partially in a lump sum and partially in an annuity (or another variation of a split option), then the entire payment option – even the annuity portion - must be calculated using the actuarial factors (applicable interest rate and mortality table) that are required for lump sum payments under Section 417(e)(3) of the Code. In contrast, for an option that is entirely an annuity option, the plan can use its own actuarial factors for calculating the benefit.

  New proposed Treasury regulations would treat the annuity portion of these split options as separate optional forms of benefit for determining whether 417(e)(3) actuarial assumptions must be applied, so the annuity portion could be exempt even if the remainder isn't. If partial annuity/lump sum options are offered, participants would be not be faced with the "all-or-nothing" choice where if they want a lump sum payment at all, they must elect it all as an immediate payment. The treatment as separate optional forms of benefit would be especially beneficial in plans with two different types of benefit formulas for which the employer may want to provide different types of payments.

  Again, these proposed rules cannot be relied on until published as final regulations, and any future change in actuarial factors under these rules, if finalized, would still be subject to anti-cutback limitations.

- Plan sponsors are concerned that offering deferred annuity contracts under a defined contribution plan such as a 401(k) plan will subject the plan to qualified joint and survivor annuity (QJSA) and qualified preretirement survivor annuity (QPSA) requirements, and plan sponsors are unsure how to administer the spousal consent rules if they do apply. If a plan is subject to QJSA and QPSA requirements, the automatic form of benefit for a married participant must be a joint and 50% survivor annuity, and additional requirements for spousal consent, waiver, and detailed explanations are required. Most 401(k) plans are designed to be exempt from QJSA and QPSA requirements because: (1) the participant's entire balance is payable in full to the participant's spouse upon the death of the participant; (2) the participant does not elect benefits in the form of a life annuity; and (3) the plan did

not accept transfers from a plan subject to QJSA and QPSA requirements.

Newly-issued Revenue Ruling 2012-3 clarifies whether the QJSA and QPSA requirements apply to a plan that offers deferred annuity contracts as investments in the plan. The Ruling provides that a deferred annuity contract is generally exempt from QJSA/QPSA if the annuity contract provides that the participant can instead elect a lump sum payment up until the annuity payments begin, there is a full death benefit to the surviving spouse upon the participant's death (which can be elected as a lump sum or annuity option), and payments are not funded from amounts that are transferred from another plan subject to QJSA/QPSA. The spouse's consent to any other form of payment is not required until just before the annuity would begin. Even though the annuity portion will be subject to QJSA requirements if an annuity is selected and payments begin, this does not subject the remainder of the participant's account or the plan to the QJSA and QPSA requirements, so the additional administrative burden should be minimal. The Ruling also discusses several other types of deferred annuity contracts and the limited effect of the QJSA and QPSA requirements on the remainder of the account balance and plan.

- Plan sponsors are unsure how to treat rollovers from defined contribution plans to defined benefit plans under certain defined benefit plan requirements. A participant who receives a distribution from a defined contribution plan such as a 401(k) plan may wish to roll over that distribution to the participant's defined benefit plan sponsored by the same employer, in order to "convert" the defined contribution plan benefit into a lifetime income option under the defined benefit plan. Converting to an annuity under the defined benefit plan may have a lower cost than purchasing a similar annuity outside the plan.

  Newly-issued Revenue Ruling 2012-4 provides that if certain requirements are met, this type of rollover would not count against the annual limitations on the benefit from the defined benefit plan under Code Section 415, and would properly be treated as nonforfeitable employee contributions. This result applies if the rollover is converted to an annuity option under the defined benefit plan using the actuarial assumptions (applicable interest rate and mortality table) under Code Section 417(e)(3). In contrast, if the plan uses actuarial assumptions that are less favorable to the participant, so the annuity is smaller, then the nonforfeitability requirements would be violated. And if the plan instead uses actuarial assumptions that are more favorable to the participant, so the annuity is greater, then the additional benefit would be treated as due to employer contributions and would be subject to annual benefit limits under 415, or the rollover may be forbidden altogether due to funding restrictions since the defined benefit plan would be taking on more liability.

  Revenue Ruling 2012-4 does not apply with respect to rollovers made before January 1, 2013, but provides that plan sponsors are

permitted to rely on its holdings with respect to rollovers made prior to that date.

Although this new guidance answers several outstanding questions and gives us hints of the direction of some future guidance, additional questions about lifetime income options remain. For example, this guidance does not directly address all types of lifetime income solutions, such as guaranteed or systematic withdrawal products, and does not resolve significant fiduciary liability concerns with respect to selection of an annuity provider and ERISA Section 404(c) protection. Also, given participants' common preference for choosing lump sump options, additional participant education and disclosures regarding lifetime income options may be necessary in order for these changes to have much practical effect. More guidance on lifetime income options is expected later this year.

If you have any questions about your obligations under this new guidance or any other benefit plan issue, contact a member of the Benefits Law Group.

This publication is designed to provide general information on pertinent legal topics. The statements made are provided for educational purposes only. They do not constitute legal or financial advice nor do they necessarily reflect the views of Holland & Hart LLP or any of its attorneys other than the author(s). This publication is not intended to create an attorney-client relationship between you and Holland & Hart LLP. Substantive changes in the law subsequent to the date of this publication might affect the analysis or commentary. Similarly, the analysis may differ depending on the jurisdiction or circumstances. If you have specific questions as to the application of the law to your activities, you should seek the advice of your legal counsel.