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Publications

Lifetime Income Provisions Under the SECURE Act

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As the U.S. private retirement system has largely shifted away from traditional pensions in favor of a defined contribution plan savings model, a number of policymakers have expressed concerns over whether participants' expectations of retirement security will adequately be met under that model. Among these concerns are whether defined contribution plan participants will accumulate sufficient plan savings to adequately fund retirement living expenses, whether participants can afford to assume the mortality and investment risks associated with managing sources of retirement income, and the false "illusions of wealth" that can sometimes arise when a participant views his or her accumulated 401(k) account balance in isolation.

In 2010, the Department of Labor and the Treasury Department jointly solicited information on how the agencies might enhance, by regulation or otherwise, the retirement security of participants in employer sponsored retirement plans by facilitating access to, and use of, lifetime income or other arrangements designed to provide a lifetime stream of income after retirement (the "RFI").[1] The RFI was successful in spurring a great deal of public comment and debate at that time. But in the ten-year period that has followed, there have been relatively few concrete developments to report on the regulatory front.

By comparison, the SECURE Act, which includes three major lifetime income-related provisions, represents a giant step forward on the part of Congress to not only reduce some of the barriers that have traditionally discouraged the use of lifetime income products by defined contribution plans, but to also encourage participants to begin thinking about their defined contribution savings in terms of a lifetime income stream.

Below, we describe and analyze each of the SECURE Act's three lifetime income provisions. Respectively, those provisions require the delivery of lifetime income illustrations to plan participants, provide a fiduciary safe harbor for the prudent selection of lifetime income providers, and allow for the portability of lifetime income benefits that have been accumulated "in-plan" in connection with a change in providers.

Section 203. Disclosures Regarding Lifetime Income

SECURE Act section 203 amends the pension benefit statement rules under ERISA section 105 to require that individual account plans add a "lifetime income disclosure" to at least one pension benefit statement furnished to participants during a 12-month period. This lifetime income disclosure requirement will become applicable to pension benefit statements furnished more than 12 months following the later of DOL's issuance of (i) interim final rules, (ii) a model lifetime income disclosure, or (iii) assumptions used to convert total accrued benefits to lifetime income streams.[2]

As background, ERISA section 105 requires administrators of individual account plans to furnish a quarterly benefit statement to participants and beneficiaries who have the right to direct the investment of their plan accounts, and annually to participants and beneficiaries who lack investment direction rights. The contents of such benefit statements are required to include (i) the total amount of benefits accrued; (ii) the portion of total accrued benefits that are nonforfeitable, if any, or the earliest date on which accrued benefits will become nonforfeitable; and (iii) the value of each investment to which individual account assets are allocated. Benefit statements for self-directed plans must also contain certain explanations about the participant's plan investment rights, the importance of a well-balanced and diversified investment portfolio, and furnish notice of a DOL internet website providing information about investing. The SECURE Act adds the new lifetime income disclosure content requirement discussed below.

The new lifetime income disclosure must express a participant's total accrued benefits as a "lifetime income stream" (*i.e.*, as the monthly payment amounts that a participant or beneficiary would receive if the account balance were applied to provide a lifetime income stream, based on assumptions to be specified in a future DOL rule.) Two sets of lifetime income stream illustrations are required. The first is a qualified joint and survivor lifetime income stream, based on the assumption that the participant has a spouse of equal age.[3] The second lifetime income stream to be illustrated is a single life annuity.

DOL is required to issue interim final rules within one year of the SECURE Act's enactment (*i.e.*, by December 20, 2020) prescribing the assumptions plan administrators are to use when converting total accrued benefits into lifetime income stream illustrations. For purposes of developing these interim final rules, DOL is expressly granted the flexibility either to prescribe a single set of assumptions or ranges of permissible assumptions.[4] Within the same one year time period, DOL is also required to issue a "model lifetime income disclosure." That model is required to contain a series of prescribed explanations including explanations (i) that the lifetime income stream illustration is merely that; (ii) that if the participant's total accrued benefits were actually applied to the purchase of a lifetime income stream, the monthly amounts payable could vary substantially from the amounts illustrated; and (iii) of the assumptions on which the lifetime income stream equivalents were determined.

Plan fiduciaries, plan sponsors and all other persons are relieved from any liability under Title I of ERISA for providing lifetime income disclosures to participants so long as the disclosures are based upon the assumptions and rules specified by DOL and include the explanations contained in the DOL's model lifetime include disclosure.[5]

Section 204. Fiduciary Safe Harbor for the Selection of Lifetime Income Provider

SECURE Act section 204 enacts ERISA section 404(e), a new, optional safe harbor (the "New Safe Harbor") for the prudent selection of a "guaranteed retirement income contract" or "GRIC" on behalf of an individual account plan. The term "guaranteed retirement income contract" is defined broadly to include both payout products and products providing for the accumulation of retirement income guarantees on an in-plan basis. A GRIC is –

"an annuity contract for a fixed term or a contract (or provision or feature thereof) which provides guaranteed benefits annually (or more frequently) for at least the remainder of the life of the participant or the joint lives of the participant and the participant's designated beneficiary as part of an individual account plan."

The provisions of the New Safe Harbor have their origins in, and are derived from, the pre-existing regulatory safe harbor at 29 CFR § 2550.404a-4 for the selection of individual account plan benefit distribution providers, which was adopted by DOL in 2008 (the "2008 Safe Harbor"). The 2008 Safe Harbor describes a series of steps for a plan fiduciary to engage in when prudently selecting a benefit distribution annuity provider for an individual account plan. Under the 2008 Safe Harbor, such a fiduciary must –

1. engage in an objective, thorough and analytical search to select a provider;[6]

2. *appropriately* consider information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;[7]

3. *appropriately* consider the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services provided;[8]

4. *appropriately* conclude that, at the "time of selection" the annuity provider is financially able to make all future payments under the contract and that the cost of the contract is reasonable in relation to the benefits and services to be provided;[9] and

5. *if necessary*, consult with appropriate expert(s) for purposes of compliance with the above provisions.[10]

The 2008 Safe Harbor also includes a provision further explaining the phrase "time of selection" as used in condition 4, above.[11] In its adopting release, DOL explained that a number of commenters had expressed concern that plan fiduciaries would need to comply with the safe harbor conditions where a plan might utilize the product's asset accumulation features, even though the plan might not annuitize benefits under the arrangement.[12] DOL indicated that it wished to clarify that the safe harbor conditions applied only to the decision to purchase a distribution annuity (i.e., to annuitize and distribute a plan benefit).[13] For that reason, "time of selection" is defined to mean either –

- the time that the annuity provider and contract are selected for purposes of contemporaneously distributing benefits to a specific participant or beneficiary; or
- the time that the annuity provider is selected to provide annuity contracts at future dates to participants or beneficiaries, provided that the selecting fiduciary periodically reviews the continuing appropriateness of the conclusion that the provider is financially able to make all future payments under the contract and that the cost of the contract is reasonable in relation to the benefits and services provided, taking into account the conditions of the safe harbor.[14]

Over the years many plan fiduciaries have expressed discomfort about relying on the 2008 Safe Harbor. In large measure, that discomfort stems from the vague wording of several of the conditions (see the italicized terms "appropriately" and "if necessary" in conditions 2-5 as listed above). Fiduciaries were concerned that, given these subjectively worded standards, they could not confidently conclude the conditions had been satisfied. More significantly, the 2008 Safe Harbor includes requirements that a fiduciary appropriately assess and conclude, respectively, that a selected annuity provider be able to make "all future payments under the contract."

Given the lengthy duration of annuity provider payout obligations – which may exceed 30 years – many plan fiduciaries remained concerned about the potential for claims of a fiduciary breach, and resulting liability, if a provider that appeared financially sound and fully capable of satisfying all of its obligations at the time of its selection should experience financial distress many years later. A particular concern was that, with the benefit of hindsight, plaintiffs could allege that the seeds of an insurer's ultimate financial distress had already been sown at the time of its selection, and that the fiduciaries responsible for the insurer's selection would have detected those problems had they made appropriate assessments and drawn appropriate conclusions, but failed to do so and therefore also failed to satisfy the conditions of the safe harbor.

The New Safe Harbor addresses these concerns. It also expands the scope of available safe harbor relief to include not only the selection of benefit distribution providers (*i.e.*, providers of "payout annuities"), but also providers of products that allow for the accumulation of retirement income guarantees on an "in-plan" basis. To make the safe harbor easier to rely upon, the new law modifies several of the conditions of the 2008 Safe Harbor, dispenses with certain others and, most importantly, facilitates satisfaction of conditions related to assessing the insurer's financial strength by deeming those conditions to have been met where the insurer delivers certain written representations to the selecting fiduciary.

Absent from the New Safe Harbor is condition 5 of the 2008 Safe Harbor requiring that fiduciaries, when necessary, consult with experts. Conditions 1 through 4 of the 2008 Safe Harbor are largely retained but have been re-worded to avoid the use of vague terms (in this regard, the word "appropriately" is not used).

As noted above, perhaps the most significant feature of the New Safe Harbor is a provision that deems the selecting fiduciary to have satisfied the conditions related to the adequacy of the insurer's financial capabilities upon receipt of a specified set of written representations from the insurer, subject to the proviso that, after receiving those representations, the fiduciary must not have received notice of any change in the insurer's circumstances or other information which would cause it to question the representations provided. The representations to be provided by the insurer are as follows –

1. the insurer is licensed to offer guaranteed retirement income contracts;
2. the insurer, at the time of selection and for each of the immediately preceding 7 plan years:

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    - operates under a certificate of authority from the insurance commissioner of its domiciliary state that has not been revoked or suspended;

- has filed audited financial statements in accordance with the laws of its domiciliary state;
- maintains and has maintained reserves which satisfy all the statutory requirements of all states in which the insurer does business;
- is not operating under an order of suspension, rehabilitation, or liquidation;

3. the insurer undergoes, at least every 5 years, a financial examination by the insurance commissioner of its domiciliary state; and

4. the insurer will notify the fiduciary of any change in circumstances after providing the above representations which would preclude the insurer from making such representations at the time of issuance of the contract.[15]

Similar to the 2008 Safe Harbor, the "time of selection" under the New Safe Harbor means the time that the annuity provider and contract are selected for distribution of benefits to a specific participant or beneficiary or the time that the annuity provider is selected to provide benefits at future dates to participants or beneficiaries, provided that the selecting fiduciary "periodically reviews" the continuing appropriateness of its conclusions regarding the financial capability of the insurer. A fiduciary is deemed to perform a periodic review if it receives the written representation (described above) from the insurer on an annual basis, unless it receives the notice of a change in circumstances (described above) or it becomes aware of facts that would cause the fiduciary to question the insurer's representations.

As noted, the New Safe Harbor includes conditions relating to an evaluation of the reasonableness of costs associated with the product in relation to contract benefits and features. With respect to that issue, the New Safe Harbor includes a provision clarifying that a fiduciary is not required to select the lowest cost contract and may consider the value of the contract (such as features and benefits and attributes of the insurer, including the insurer's financial strength) in conjunction with the cost.

Finally, and for avoidance of any doubt, the New Safe Harbor provides that where a plan fiduciary satisfies its conditions, it is relieved of all liability for any losses that may result due to an insurer's inability to satisfy its financial obligations under the contract with respect to the distribution of any benefit, or an investment in the contract by or on behalf of a participant or beneficiary pursuant to the selected annuity contract.

Section 109. Portability of Lifetime Income Options

Section 109 of the SECURE Act amends section 401(a) of the Internal Revenue Code by adding a new paragraph (38) enabling defined contribution plans to include provisions allowing, on or after the date that is 90 days prior to the date on which a lifetime income investment is no longer authorized to be held as an investment under the plan, either (i) "qualified distributions of a lifetime income investment," or (ii) "distributions of a lifetime income investment in the form of a qualified plan distribution annuity contract".[16] Substantially similar amendments are also made to Code sections 403(b)(11), 403(b)(7) and 457(d)(1) for purposes of extending the same level of portability to tax deferred annuities and custody accounts, and to governmental deferred compensation plans, respectively.

For purposes of the amended Code provisions

- a "*lifetime income investment*" is defined to mean – a plan investment option providing participants with election rights (i) which not uniformly available with respect to other plan investment options (i.e., election rights that are distinct to that particular option); and (ii) which relate to a lifetime income feature available through a contract or arrangement under the plan;
- a "*lifetime income feature*" is one which (i) guarantees a minimum level of income annually or more frequently for at least the remainder of the life of the participant or the joint lives of the participant and his/her designated beneficiary, or (ii) an annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments over the life of the participant or the joint lives of the participant and his/her designated beneficiary;
- a "*qualified distribution*" is defined as a direct trustee to trustee transfer, as described in Code section 401(a)(31)(A) to an "eligible retirement plan" (as defined in Code section 402(c)(8)(B)); and
- a "*qualified plan distribution annuity contract*" means an annuity contract purchased for a participant and distributed to the participant by a plan or contract described in Code section 402(c)(8)(B)(iii)-(vi).[17]

Allowing plans to include lifetime income portability provisions largely solves what has up to now been a significant technical challenge to the use of in-plan lifetime income products. Many such products have features that can only be supported by one or a few investment platform providers. Until the SECURE Act, plans that had adopted and allowed participants to invest in such a product faced a dilemma if they ever wished to move to a new recordkeeping platform that did not support the product. If the plan elected to surrender the lifetime income product for purposes of transitioning to the new platform, the lifetime income benefits associated with the product would typically be lost. In order for the plan to both maintain the accumulated lifetime income benefits and transition to a new recordkeeper, it would often need to "leave behind" its lifetime income product holding with the original recordkeeper. This would leave the plan with two recordkeepers – the original, for purposes of maintaining the lifetime income product, and the successor, for purposes of maintaining records of all other plan investments. Coordinating the two sets of records for purposes of administering the plan often proved difficult and unwieldy.

The SECURE Act's solution for this problem is to permit both in-service trustee to trustee transfers of participants' lifetime income product interests to other eligible plans, including IRAs, and the purchase of distributed annuities for purposes of preserving a participant's accumulated benefit, during the 90 day period preceding the plan's discontinuance of the product. Since most insurers that offer lifetime income products in the employer-sponsored plan market also make the same product available through a retail IRA vehicle, plan participants that have accumulated in-plan lifetime income guarantees will be positioned to readily preserve those features to a successor vehicle if the plan decides to terminate the original arrangement.