Employee Benefits Corner

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Lifetime Income Features in Retirement Plans

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In the early 2000s, legislative changes were enacted to help simplify the 401(k) plan process, such as by simplifying the process for eliminating annuity forms of benefit from 401(k) plans. However, since that time the number of active defined benefit plans has continued to decrease and, for many employees, their 401(k) plans have become their primary retirement savings vehicle for their employers. Accordingly, significant attention is now being given to how to help employees manage their 401(k) plans to maximize the likelihood that their retirement savings will last through their retirement years. A key feature of this attention has been a focus on how lifetime income features can play a role in the modern retirement plan system. This focus has involved both innovative product designs from the private sector and a joint February 2010 request from the Departments of Labor and Treasury for information (RFI) regarding lifetime income options.[1]

There are two key pieces of guidance from the IRS[2] and DOL that are expected to be released in 2012. The first, from the IRS, was a series of guidance issued in February 2012 that is designed to facilitate the use of lifetime income features in the retirement plan system. The second, which is expected to be issued later in 2012, is guidance on disclosing the lifetime income steam value of a participant's defined contribution account.

In this column, we discuss the already released IRS guidance and briefly discuss the potential parameters of the upcoming DOL guidance.

IRS Guidance

In General

After reviewing and evaluating the RFI responses, the IRS provided an initial round of guidance in February 2012. This guidance package consists of four parts, the first two of which generally focus on defined contribution plans, and the second two of which generally focus on defined benefit plans.

- Defined Contribution Plan–Focused Guidance
  - **Rev. Rul. 2012-3.**[3] This guidance discusses how the qualified joint and survivor and qualified pre-retirement survivor annuity rules apply to certain annuity contracts.
  - **Proposed Code Sec. 401(a)(9) Regulations.** These proposed regulations would modify the Code Sec. 401(a)(9) required minimum distribution rules to encourage the use of qualified longevity annuity contracts (QLACs).
- Defined Benefit Plan–Focused Guidance
  - **Rev. Rul. 2012-4.**[4] This guidance provides clarification of how defined contribution plan benefits can be annuitized *via* rollover to a defined benefit plan.
  - **Notice of Proposed Code Sec. 417(e) Regulations.** These proposed regulations would simplify the process by which a split benefit comprised in one part of an annuity and in one part of a nonannuity form of payment is calculated under the Code Sec. 417 rules.

This guidance is a significant first step in attempting to encourage the increased use of lifetime income options. There is likely to be further requests for and hopefully further rounds of IRS guidance that provide further flexibility in features, products (such as those that offer guaranteed lifetime withdrawal payments), and approaches to providing lifetime income options in retirement plans.

Defined Contribution Plan–Focused Guidance

With defined contribution plans playing a more and more dominant role in employees' retirement savings, the IRS lifetime income guidance provides two pieces of guidance specifically focused on defined contribution plans.

Rev. Rul. 2012-3

In recent years, some plan sponsors have added annuity contracts as features either used "inside" a defined contribution plan or as an option for purchase with a distribution from a defined contribution plan. A key concern of these plan sponsors has been how the qualified joint and survivor annuity (QJSA) and qualified pre-retirement survivor annuity (QPSA) rules under Code Secs. 401(a)(11) and 417 would apply to defined contribution plans that add these annuity contracts inside their 401(k) plans. Rev. Rul. 2012-3 provides some significant and helpful clarification of how the QJSA and QPSA rules apply.

Consistent with a straightforward reading of the Code Sec. 401(a)(11) and 417 rules, Rev. Rul. 2012-3 does not waive the application of the QJSA and QPSA rules to 401(k) plans that include annuity contracts in the plan. However, Rev. Rul. 2012-3 does provide significant relief from when these rules apply, only leaving a limited set of circumstances in which a plan will be required to comply with the QJSA and QPSA rules as follows:[5]

- **Investments in a Deferred Annuity Contract—Transfer-out Permitted.** Where a 401(k) plan offers a deferred annuity contract as an investment option but also allows the transfer out of amounts invested in the annuity contract at any time and where a participant's surviving spouse or beneficiary could receive the accrued benefit in the contract on the participant's death in a lump sum, the QJSA and QPSA rules will not apply until there is an annuity starting date (*i.e.*, the date the participant is "locked in" to the annuity). The standard spousal consent rules would apply prior to a participant's annuity starting date.
- **Investments in a Deferred Annuity Contract—No Transfer-out Permitted.** Where a 401(k) plan offers a deferred annuity contract as an investment option but does not allow the transfer out of amounts invested in the annuity contract and lump-sum payments are not permitted, the QJSA and QPSA rules apply immediate upon investment (*i.e.*, the date the participant is "locked in" to the annuity). The plan would need to satisfy the QPSA notice and consent rules as might be applicable based on specific facts.

As noted above, a key uncertainty that remains to be addressed is how other annuity products, such as those offering additional features not addressed in Rev. Rul. 2012-3, would be treated under the Code. Hopefully future guidance will provide further clarification.

Proposed Code Sec. 401(a)(9) Regulations

The second defined contribution–focused guidance addresses a key potential impediment of adding lifetime income features to 401(k) plans—the Code Sec. 401(a)(9) required minimum distribution regulations ("QLAC Regulations"). Prior to the issuance of the QLAC Regulations, significant concerns had been expressed as to how an annuity contract could be incorporated into a 401(k) plan without requiring pre-annuitization distributions from the 401(k) plan that would require the use of assets held in the annuity contract.

In general, under Code Sec. 401(a)(9), amounts payable under an annuity contract are subject to the Code Sec. 401(a)(9) required minimum distribution rules that apply to an account base plan until a benefit is annuitized.[6] As a result, payments under annuity contracts can be required to commence at an earlier date (or even worse, required minimum may be miscalculated due to the potential complexity of including annuity contracts in account-style RMD calculations).

The QLAC Regulations would address these concerns by providing that where a QLAC is held in a participant's account, the value of the QLAC need not be included in calculating the required minimum distribution under the pre-annuitization account-based rules. The effect of this rule is that a QLAC could be used for future required minimum distribution payments without the need to worry that the investment in the QLAC would need to be included in required minimum distribution payments when a participant reaches his or her required beginning date. To satisfy the QLAC requirements, the following rules will need to be satisfied:

- **Scope of Rule.** The QLAC Regulations would apply to most defined contribution plans and IRAs but would not apply to Roth IRAs and defined benefit plans.
- **Limit on QLAC Premiums.** The premiums that may be paid on a QLAC would be limited to the lesser of $100,000 (subject to inflation) or 25 percent of the participant's account balance (subject to certain aggregation rules). If either rule is violated, the entire contract would cease to be a QLAC, thus likely triggering additional required minimum distribution on a going forward basis.
- **Age at Commencement of QLAC Benefits.** A QLAC must begin payment of annuity benefits no later than the first day of the month coincident with or following a participant's attainment of age 85 (as adjusted for changes in mortality as determined by the IRS). A QLAC may also commence at an earlier date (with a lower periodic payment).
- **Benefits Payable After a Participant's Death.** The QLAC Regulations would apply strict requirements to payments after a participant's death. Many common features, from a lump-sum option to certain forms of payment, would not permitted. Instead, where the sole beneficiary is a participant's surviving spouse, an annuity (up to 100 percent of the payment payable to participant prior to his or her death) would be required to be paid. Alternatively, where the beneficiary is not a participant's surviving spouse, an annuity subject to the minimum distribution incidental benefit rules would be required to be paid. The post-death lifetime payment commencement rules would also apply where a participant dies prior to the participant's required beginning date.
- **Contract Features.** As already noted, QLACs would be very precisely defined. Certain common types of annuities, from variable annuities to equity-indexed contracts, would not be permitted. This rule is apparently premised on the concept that a QLAC is designed to provide a lifetime income stream, not to provide an annuity wrapper around various investment options. The contract must also state whether it is intended to be a QLAC.
- **Reporting and Disclosure.** There would be several levels of reporting a disclosure:
  - **Issuer Disclosure.** Similar to IRA disclosure statements, issuers of QLACs would be required to provide: details on the limits on QLAC premiums, when payments would commence under the QLAC, estimates of the amount of the QLAC payments, disclosure regarding the fact that a QLAC cannot be commuted or surrendered, a description of the death benefits payable before and after a participant's death, a description of the administrative procedures under the QLAC, and any other IRS-required information. State law disclosures would also continue to apply.
  - **Annual Reporting to IRS and Participant.** The following information would also be required to be provided to the IRS and participants on an annual basis: contact in-

formation for the issuer (and how to obtain additional information), the participant's contact information, plan contact information (if applicable), the expected date of commencement, the periodic benefit payable at commencement (and whether the commencement date may be accelerated), and details on the amount of each QLAC premium payment made, including the date paid. The annual report would be required from the date the QLAC is first purchased until the participant reaches age 85 or dies, provided, however, that annual report would also have to continue after a participant's death if payments were made solely to a participant's surviving spouse (but only until the spouse commenced payments or died).

- **Implementation in Plans.** Many 401(k) plans have implemented Code Sec. 401(a)(9) through the incorporation by reference of the required minimum distribution rules and/or through the use of the IRS' model amendment for Code Sec. 401(a)(9). It is not currently clear if or how QLACs would need to be addressed in plan documents. Further, it is likely additional changes to summary plan descriptions and other fee disclosures required by the DOL would be necessary.

Notably, the QLAC Regulations are only in proposed form at this time with a proposed effective date of January 1, 2013, and may not be relied on. It is possible that a final version of these QLAC Regulations will provide additional flexibility, although the exact parameters of this increased flexibility (if any) is unclear.

Defined Benefit Plan–Focused Guidance

Recently, much attention has been paid to the decline defined benefit plan system. However, there are still many active defined benefit plans covering a sizeable portion of the workforce. Consistent with this continued role for defined benefit plans, the IRS lifetime income guidance provides two pieces of guidance specifically focused on defined benefit plans.

Rev. Rul. 2012-4

Although not present in many plans, over the years, a number of employers' defined benefit plans have been amended to permit employees participating in the employer's defined contribution and defined benefit plans to roll distributions from an employer's defined contribution plan into the defined benefit plan, which is subsequently annuitized, thus providing a lifetime income stream based on the defined contribution plan benefit. In Rev. Rul. 2012-4, the IRS provides guidance specifically addressing the rules governing such an approach. Notably, Rev. Rul. 2012-4 applies prospectively only to rollovers made on or after January 1, 2013.

In its analysis, the IRS concludes that a rollover is treated like a "mandatory employee contribution" to the defined benefit plan. Because the IRS concludes that a rollover is treated like a mandatory employee contribution, when calculating an annuity, the plan is required to use the Code Sec. 417(e) interest and mortality factors that would regularly apply to mandatory employee contributions. Further, the rollover contributions must be nonforfeitable consistent with Code Sec. 411(a)(1). The effect of these rules is that, once Rev. Rul. 2012-4 goes into effect, defined benefit plans will either need to utilize the Code Sec. 417(e) interest rate and mortality table or face having any amounts payable under more generous annuity factors subject to testing under the Code Sec. 415(b) limits, which could add complexity to defined benefit plan administration. Further, when rollovers are permitted, special attention should be paid to the qualified joint and survivor annuity and qualified pre-retirement survivor annuity rules, whether the plan is at least 60 percent funded (*i.e.*, not subject to restrictions on additional accruals that could be affected by a rollover contribution), and how plan communications, including summary plan descriptions, should reflect this rule.

Notice of Proposed Code Sec. 417(e) Regulations

The second defined benefit–focused piece of lifetime income guidance provides notice of proposed amendments to the Code Sec. 417(e) regulations that would be designed to encourage and simplify the process of offering partial payment in a benefit form subject to Code Sec. 417(e)'s interest rate and mortality table rules (*i.e.*, a lump sum) and annuity forms of benefit. Under these proposed regulations, the annuity benefit would remain subject to a defined benefit plan's "regular" annuity assumptions while the lump-sum benefit would be subject to the applicable Code Sec. 417(e) factors. It is anticipated that the following three categories of benefit payments would be eligible to utilize this revised rule: (1) accrued benefit determined under separate formulas, (2) separate distribution elections for portions of the accrued benefit, and (3) lump sum only available for a portion of the accrued benefit.

Formal regulation text has yet to be issued and may not be relied on at this time. Further, the IRS has noted that the anti-cutback provisions of Code Sec. 411(d)(6) will still apply to plans that elect to implement the changes to be reflected in the proposed regulations, thus making it unclear as to the extent to which these rules will be implemented in defined benefit plans.

DOL Guidance

Although DOL guidance has yet to be issued, many expect that later in 2012, the DOL will issue rules governing the disclosure of the lifetime income value of a participant's defined contribution account balance. At this time, a number of questions have been raised about how this guidance would operate, including whether and how account balances would be projected to an expected retirement age; what assumptions would be used for projection; what actuarial factors and assumptions would be used to convert account balances into lifetime payment projections; and whether marital status would be taken into account for estimates.

Endnotes

1 *See* Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, *http://webapps.dol.gov/federalregister/HtmlDisplay.aspx?DocId=23512&AgencyId=8&DocumentType=1,* Feb. 2, 2010.

2 For purposes of simplicity, we use the term "IRS" to refer to guidance issued by the Department of the Treasury.

3 Rev. Rul. 2012-3, IRB 2012-8, 383.

4 Rev. Rul. 2012-4, IRB 2012-8, 386.

5 The summaries below are general in nature. Specific additional facts, such as how an annuity is invested and what type of benefit guarantee is provided, should also be considered in interpreting this guidance.

6 Reg. §1.401(a)(9)-6, Q&A 12.