Legal Developments

QLACs and Lifetime Income Makes the IRS Guidance Plan List

This column discusses the existing IRS Guidance and what additional guidance is needed for lifetime income products.

By Elizabeth Thomas Dold

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As early as 2010, when the Internal Revenue Service (IRS) and the Department of Labor (DOL) made their initial Request for Information on how the agencies could best facilitate lifetime income products for retirement plans, there has been a strong interest in providing lifetime income options to participants within defined contribution plans. This need has only increased over the years as more and more defined contribution plans move away from offering an annuity form of benefit, and as the number of defined benefit plans declines. Employers have been anticipating products that help provide for lifetime income for participants, and address market and longevity risks.

In 2012, the IRS issued a series of guidance that was designed to help facilitate lifetime income products. In 2014, the IRS finalized the regulations that developed a new product, called a Qualifying Longevity Annuity Contract (QLAC) for the IRA and qualified plan market (governmental 457(b), 403(b), and defined contribution 401(a) plans). In August 2016, the US Government Accountability Office issued a report entitled "401(k) Plans DOL Could Take Steps to Improve Retirement Income Options for Plan Participants," indicating that more work still needed to be done to facilitate these products within qualified plans. At the same time, the IRS's 2016-2017 Priority Guidance Plan was announced which included as two of their guidance items (1) additional guidance regarding QLACs, and (2) additional guidance on issues relating to lifetime income from retirement plans and IRAs, recognizing the need for additional guidance in this area. This article reviews the existing IRS guidance and what additional IRS guidance is needed to facilitate mass appeal of these products within pre-approved and individually designed qualified plans.

Increased Focus on Lifetime Income Products

There are a number of reasons why it is time to focus our energies into lifetime income products. The first key reason is that there has been a real shift from defined benefit to a defined contribution system over the past 10 plus years, shifting the investment/market risks and longevity risks from the employer to the employee. Even with all the various investment tools and education available, there is no replacement for a guaranteed income flow. Second, individuals are living longer, so there is improved longevity. It is not uncommon for a defined contribution account balance to have to provide for at least 20 years of retirement income.

To meet this demand, there are a variety of different lifetime income tools. They include traditional annuities, QLACs, guaranteed lifetime withdrawal benefits and guaranteed minimum withdrawal benefits (collectively, GLWBs), longevity insurance, managed payout and retirement income mutual funds, managed retirement income accounts, and target date funds (TDF) (which may be used in combination with the other products). We focus on two of these products—QLACs and GLWBs—which are in need of additional IRS guidance.

QLAC

QLACs were designed to provide relief from the minimum required distribution rules under Code Section 401(a)(9), which generally provides that a

participant must commence benefits when they reach the later of age 70½ or retirement. The IRS and Treasury developed detailed requirements for such deferred annuities, including:

- *Limit on premium*. Cannot exceed lesser of $125,000 or 25 percent of the participant's account balance.
- *Maximum age of commencement*. Age 85.
- *Death benefit*. Only a return of premium feature, plus certain limited survivor benefits are permitted.
- *Limits on contract features*. QLACs exclude variable annuity contracts, equity-indexed contracts, and similar contracts. The contract cannot permit commutation benefits, cash surrender value, *etc.*
- *Disclosures*. Detailed participant and IRS disclosures up front and annually are required. [*See* IRS Form 1098-Q.]

Unfortunately, there has been little QLAC activity in the qualified plan space. While the regulations set forth rather strict parameters, the issues that are not addressed in the regulations cause some hesitation to enter the market. The key issue being how to comply with the complex spousal consent and spousal benefit requirements.

A. Spousal Consent/Benefits Issues

Many defined contribution plans are profit-sharing exception plans, which means they do not offer an annuity form of benefit but rather provide that on death, the surviving spouse is entitled to the participant's remaining account balance. [I.R.C. § 401(a)(11)(B)(iii); Treas. Reg. § 1.401(a)-20, Q&A-4] However, if a plan sponsor wants to help address longevity risks of the participant outliving their retirement savings, the IRS developed a QLAC product that generally provides for lifetime income starting around age 80. When an annuity is being offered within a plan that simply provides lump-sum or installment payments, the plan sponsor now has to amend its plan to offer an annuity, and the first question raised is how will the plan sponsor satisfy the qualified joint and survivor annuity (QJSA) and qualified preretirement survivor annuity (QPSA) rules if the plan offers a QLAC?

As the QLAC is a life annuity, it triggers compliance with QJSA and QPSA rules for a portion of the plan. Then the question is how to best interpret Revenue Ruling 2012-3 regarding how the QLAC satisfies the QJSA and QPSA rules.

Revenue Ruling 2012-3 provides a traditional deferred annuity contract that triggers QJSA and QPSA rules for the portion of the plan invested in the annuity, provided that separate accounting is maintained. In general, the QJSA rules are triggered when benefit payments commence, and not merely when a participant invests in a deferred annuity. However, if the contract is designed to (1) prohibit subsequent transfers, (2) pay benefits only in the form of an annuity (*e.g.*, no lump-sum option), and (3) the amount payable under the contract is fixed when the investment is made, immediate compliance with the QJSA/QPSA rules is required for that portion of the account.

Ideally, the pending guidance would take the position that the QLAC, which is in the form of a 50 percent joint and survivor annuity, meets the QJSA requirements and that the "annuity starting date" for this purpose is the date of purchase of the QLAC. With the very limited death benefits features permitted under a QLAC and the intent of the product to provide longevity protection, this approach makes a lot of sense, and avoids adverse selection if the annuity starting date is delayed until payments commence.

B. Benefits, Rights, and Features (BRF) Testing

Qualified plans are subject to various nondiscrimination requirements under Code Section 401(a)(4). Included in these rules is a requirement that all benefits, rights, and features offered under a plan must not discriminate in favor of highly compensated employees. [Treas. Reg. § 1.401(a)(4)-4]

Concerns arise where the QLAC (as either part of an investment form or as an optional form of benefit) is not available to all participants in the plan, or if reasonable restrictions are in place, such as minimum account balance, minimum age, citizenship, or non-Roth accounts, even though the QLAC investment may not be well suited for all investors.

Historically, the IRS has provided very limited relief in this area where market restrictions limit what is available under the plan, through no fault of the plan sponsor. However, in 2014, the IRS provided relief in Notice 2014-66 by treating a series of TDFs offering an age restricted traditional deferred annuity as a single BRF, provided that (1) the series of TDFs were designed to serve as a single integrated investment program, (2) the annuities offered do not provide a GLWB, (3) there are no employer securities of non-public companies, and (4) the same rights or features (other than investment mix) and same fees paid from plan assets. Ideally, this guidance would extend to similarly situated products, even if slightly outside the four corners of the guidance.

C. Cost-of-Living Adjustment

The QLAC regulations expressly permits a cost-of-living adjustment (COLA) to increase payments as set forth in Treasury Regulations Section 1.401(a)(9)-6, Q&A-14(b). [Treas. Reg. §. 1.401(a)(9)-6, Q&A-17(d)(4)(ii)] These rules permit the following cost-of-living adjustments:

- A consumer price index that is based on prices of all items (or all items excluding food and energy) and issued by the Bureau of Labor Statistics, including an index for a specific population (such as urban consumers or urban wage earners and clerical workers) and an index for a geographic area or areas (such as a given metropolitan area or state);
- A percentage adjustment based on a cost-of-living index described in the paragraph above, or a fixed percentage if less. In any year when the cost-of-living index is lower than the fixed percentage, the fixed percentage may be treated as an increase in an eligible cost-of-living index, provided it does not exceed the sum of:
  - (i) the cost-of-living index for that year, and
  - (ii) the accumulated excess of the annual cost-of-living index from each prior year over the fixed annual percentage used in that year (reduced by any amount previously utilized under this paragraph); or
- A percentage adjustment based on the increase in compensation for the position held by the employee at the time of retirement, and provided under either the terms of a governmental plan within the meaning of Code Section 414(d) or under the terms of a nongovernmental plan as in effect on April 17, 2002.

However, the regulations do not expressly cross-reference Q&A-14(c) that permits annuities from a life insurance company to offer a more flexible COLA that complies with the minimum income threshold test (MITT), which ideally would be expressly permitted for QLAC, along with guidance on how to apply the MITT rules for such a deferred annuity.

GLWBs

There are various products in the market designed to provide a guaranteed lifetime income option in a defined contribution plan. The structure can include (1) direct (GLWB provider is also the plan recordkeeper) verses indirect (unrelated plan recordkeeper) arrangement, (2) single- or multiple-insurer structures, (3) group annuity or synthetic annuity approach, or (4) guarantee applied to target date fund, balanced funds, or managed accounts.

For example, in exchange for a guaranteed fee, the insurer guarantees a lifetime withdrawal amount based on an "income base" that is protected from market loss. After the participant "locks in," a lifetime withdrawal amount is established. As long as no excess withdrawals are taken, that lifetime withdrawal continues for life, even after market value of the account is reduced to zero. Any remaining market value may be available as a death benefit.

As the products vary, there has been very little IRS guidance issued on how the various plan qualification rules are to be applied, or how the payments are treated for reporting and withholding purposes. Any guidance issued in this area should be prospective in nature, and ideally in the form of safe harbor guidance to accommodate the various product designs. Important areas needing IRS (or legislative) guidance are set forth below, along with what plan document language is required and how these products can be added without loss of reliance on existing determination or opinion/advisory letters.

A. Spousal Consent/Benefits Issues

If the lifetime income guarantee is treated as a "life annuity," then compliance with the QJSA and QPSA rules is triggered, which for a plan that otherwise meets the profit-sharing exception rules under Code Section 401(a)(11)(B)(iii) and Treasury Regulations Section 1.401(a)-20, Q&A-4, adds a new level of complexity to the plan. These rules raise a number of concerns, including: (1) will the lifetime income product meet the QJSA and QPSA requirements or will another traditional annuity need to be offered, (2) at what point are these rules triggered (*e.g.*, how would the principles of Revenue Ruling 2012-3 be applied to lifetime income products), and (3) how does a subsequent divorce or marriage impact the lifetime benefit.

If the lifetime income products are simply treated as investment options and installment payments and not as an optional form of benefit that meets the requirements of a "life annuity," for which there is no clear definition, these complexities could be avoided.

B. BRF Testing

Age conditions on funds or features (*e.g.*, the ability to receive guarantees) raise BRF testing concerns under Code Section 401(a)(4) and Treasury

Regulations Section 1.401(a)(4)-4. A right to a particular form of investment and an optional form of benefit (installments or annuity), are each a BRF. Therefore, a lifetime income feature that includes a minimum age or minimum account balance, or that is paid in installments or an annuity that is not otherwise available under the plan, raises BRF concerns.

Notice 2014-66 provided very favorable guidance regarding the use of a deferred annuity with target date funds, and recognized that plans should not be subject to testing requirements merely because the nature of the product mandated an age restriction. However, the guidance by its terms does not currently extend to GLWBs, so testing may be required unless the IRS extends this relief.

C. Accrued Benefit

If the lifetime income guarantee feature is treated as part of the participant's accrued benefit, rather than investment option or ancillary benefit, it may raise anti-cutback (or nonforfeitability) questions, which are difficult issues for investment products designed to provide participant flexibility. For a defined contribution plan, the accrued benefit is the participant's account balance, but it also includes an optional form of benefit (subject to some cutback relief). Importantly, a right to a particular form of investment, as well as ancillary life insurance protection, is not part of the accrued benefit. Inherent in the product designs is often an ability for the participant to elect out of the lifetime income feature and to change the time and form of distributions, which raise concerns if the feature was not simply treated as an investment option, consistent with Notice 2014-66.

Moreover, a change by the insurer in the product, or a change in investment lineup by the plan sponsor following its fiduciary duties (or as a result of a change in recordkeeper that is not able to administer the feature) ideally would not raise plan qualification concerns for employers.

D. Portability

To help preserve the participant's guaranteed benefit, portability of the guarantee is also important. There is pending legislation that would permit a direct rollover to an IRA or a distribution of the guarantee feature through a qualified plan distributed annuity (QPDA) prior to a distributable event (*e.g.*, prior to age 59½, termination of employment). [*See, e.g.*, S. 3471, 114th Cong. § 113 (2016).]

Conclusion

In light of the increased focus on defined contribution plans, and the importance of participants having enough savings to provide for them through their retirement years, lifetime income products—including QLACs and GLWBs—will continue to play an important role. ■