TAX MANAGEMENT

MEMORANDUM



# Income Guarantees in Defined Contribution Plans

*by Robert J. Toth, Jr., Esq,*
*Law Offices of Robert J. Toth*
*Fort Wayne, IN*

## INTRODUCTION

The traditional scheme upon which government and industry has relied in providing employer-sponsored retirement plans is based upon the concept that asset accumulation and lifetime payouts are separate functions that cannot be combined into a single program, and must be maintained under multiple, separate plans. This means that employers wanting to provide a lifetime income stream that the employee cannot outlive had to provide a Defined Benefit (DB) plan, with Defined Contribution (DC) plans being designed to allow employers to give employees the opportunity to accumulate assets to which they have access during their retirement years. Many employers have viewed both types of plans as being necessary for a financially secure retirement for their retirees, but have been forced to establish relatively cumbersome and separate processes in order to provide for both lifetime payouts and asset accumulation. Even the recently enacted ''DB-K plan,''[1] under which both a DC and a DB plan are combined into a single plan document, is still effectively treated as two different plans.

DB plans are now in a well-documented state of decline. The number of DB plans peaked in 1986 at 172,642 plans, and has since fallen to 48,579 plans in 2006, covering approximately 20 million workers. Meanwhile, DC plans increased from 544,985 plans in 1986 to 645,971 plans in 2006, covering 66 million workers [2]

There are increasing public policy concerns accompanying this decline in the DB benefit,[3] in that data is continuing to demonstrate the importance of providing lifetime income guar-

[1] §414(x). All section references herein are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder.

[2] U.S. Department of Labor Private Pension Plan Bulletin, February 2009. http://www.dol.gov/ebsa/pdf/1975-2006historicaltables.pdf.

[3] ''Automatic Annuitization: New Behavioral Strategies for Expanding Lifetime Income in 401(k)s,'' by J. Mark Iwry and John A. Turner, Retirement Security Project 2009 (Brookings).

antees to a retiree workforce.[4] An unusual coalition of the Heritage Foundation and the Brookings Institution is proposing a number of annuity initiatives designed to shore up this shortfall, including the introduction of a concept of something called ''trial annuities'' to be used in conjunction with DC plans.[5] This is all happening against a backdrop of the increasing popularity of a whole new generation of annuities that are available outside of retirement plans, designed to alleviate the consumers' fears related to the purchase of annuities.

These popular new annuity products, many of which are reliant upon sophisticated hedging strategies, truly point to the inadequacy of the traditional employer-based defined benefit plan in today's marketplace. The innovative annuity products in the marketplace include features well beyond anything that could be offered in a traditional DB plan. This includes features such as (but not limited to) the elective, periodic purchase of a pension guarantee with each payroll; the ability to access cash balances with minimum penalties; equity participation that will raise or lower the lifetime income guarantees; guaranteed minimum withdrawal benefits; guarantees of accumulated balances; guaranteed minimum income benefits with equity participation; and variable annuitization.

Unlike the insurance companies that are creating these new annuity products, employers who sponsor DB plans are not in the business of developing and providing sophisticated guarantees to meet changing employee and market needs. Additionally, plan sponsors generally have limited skills in even maintaining traditional DB benefits, much less having the resources to provide a wide variety of lifetime payout benefits that can adapt to change. They are severely restricted by a regulatory scheme that discourages innovation. Though these employers are seeing the changing nature of their workforce and retiree population, they find that the DB plan is unable to meet employee and retiree demands. DB plans are, for the most part, proverbial ''one-trick ponies,'' whose inflexibility has limited their usefulness in the current marketplace.

DC plans, on the other hand, do offer some solutions to employers' concerns about DB plans. Participants in a DC plan maintain control of investments by selecting investment choices and, upon retirement, have full access rights to the accumulated account value. DC plan account balances are ''portable,'' meaning that an employee can ''rollover'' his or her account balance into either an IRA or, upon getting another job, to another employer's DC plan. No insurance premiums are due to the PBGC. No actuarial computations are required. There are no minimum funding rules for most types of DC plans. The DC plan account balance benefits both younger and older employees alike. Employees have access to funds for certain types of emergencies. There are no funding liabilities from a DC plan that show up on a company's balance sheet. The plans are much simpler to administer and the benefit is readily visible to all employees.

Even with all of their attractive features, DC plans fail to meet an employer's benefit plan's needs because they inadequately protect retirees' interests beyond the years in which they can be gainfully employed. DC plan account balances can, and do, run out.

Employers and their consultants find themselves attempting to fashion solutions that provide some level of income protection for retirees in addition to asset accumulation and control. A common approach for DC plan retirement distributions is to provide retirees a ''systematic withdrawal'' option, which they can adjust periodically to offset increases in the cost of living. This is accomplished by the retiree directing the plan to pay monthly amounts from his or her account balance, until such time as the retiree dies or the account value becomes zero. The withdrawal rate and actual return earned will greatly influence the length of the withdrawal period.

However, the typical systematic withdrawal programs from DC plans have no guarantees. If the withdrawal rate is set too high, investment performance may not be sufficient to provide for long-term income for the participant. If the withdrawal rate is set too low, investment performance may be sufficient to provide for long-term income for the participant, but the participant's standard of living may be compromised. A balance, therefore, must be maintained and constantly monitored. With increasing life expectancies and the possibility of decreasing social security benefits, more and more individuals may be living to advanced ages faced with the prospect of outliving their retirement savings. Currently, a 65-year-old has a 55% chance of surviving to age 85. For a couple age 65, there is a 30% chance one of them will live to age 95.[6]

Until such time as Congress and the regulatory agencies fashion rules sufficient to permit the type of guarantees that gives employers the ability to properly balance flexibility with security, practitioners must work the current system in an effort to provide inno-

[4] See, for example, EBSA and IRS ''Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans,'' 75 Fed Reg. 5253 (2/2/10).

[5] ''Increasing Annuitization in 401(k) Plans with Automatic Trial Income,'' the Retirement Security Project, 2008.

[6] A2000 Individual Annuity Mortality Table.



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vative products though DC plans. This can be done only through the purchase of annuities as an investment under the DC plan. The following discusses the legal issues confronting the employer in making these arrangements while putting in perspective the elements of cost, insurer solvency and portability.

## THE ANNUITY CONTRACT

Because lifetime income guarantees can be provided only through the purchase of annuity contracts, a basic understanding of those contracts is necessary.

An annuity contract, as intimidating as it may look, is merely a contract that rests upon the general principles of contract law, and is governed by many of the same rules that apply to any other type of contract.[7] What is different about the annuity contract is its regulated nature: It contains terms necessary to address specific state insurance laws and (where applicable) federal security laws. Included, for example, may be matters that relate to accounting and investment practices, solvency, special agency rules, and rules that govern the handling of premiums. What is common in all of these contracts is that, though there may be a number of ''non-insurance'' features such as variable investment funds, they all are designed to provide a guaranteed income stream over a named person's (or persons') lifetime.[8]

Though a variety of annuity contracts that are designed for retirement plan payouts still rely heavily upon basic insurance features (such as the periodic accumulation of an insurance guarantee), the use of ''non-insurance'' features in annuity contracts is key to their flexibility. The most important non-insurance feature is the variable separate account, which has similar characteristics ''to a very substantial degree'' to the characteristics of mutual funds.[9] It is these separate account features that enable insurance companies to design hybrid products combining the features of equity accumulation guarantees with the guarantee of lifetime income.

It is important to recognize that there are limitations on the ability to negotiate the terms of an annuity contract. This is because the terms of an annuity contract are subject to review and approval by state insurance authorities. Though the amount and type of review will often vary with the type of contract, no annuity contract can be issued in a state without prior approval (or ''deemed'' approval) of the state. This means that changes to a state-approved annuity contract generally must also be submitted to the state for approval, unless the state has granted prior approval making a particular term ''amendable'' without its prior consent.

Annuity contracts purchased by a plan can be either group annuity contracts or individual annuity contracts. Each has its advantages: The benefits under an individual annuity contact are easily made portable, and the individual records are kept within the contract itself. Group annuity contracts, on the other hand, are more easily integrated into a plan's administrative system, and often offer more advantageous pricing.

## INSIDE OR OUTSIDE THE PLAN?

Insurance guarantees from defined contribution assets can be accumulated over a period of time through the periodic purchase of a benefit within a plan, or paid for with a single premium at the time the participant is ready to begin a retirement payment stream. Payments can then be made either from contracts held by the plan, or by contracts distributed from the plan.

### Issues Related to Distributing from Annuities Within a Plan

The key risk to manage when providing the insurance guarantee from within the plan is the risk of unintentionally transforming the DC plan into a DB plan.[10] Improperly structuring this benefit could result in plan disqualification and cause a plan sponsor to become liable for a DB-type of funding. There a number of other plan terms and procedures that are impacted by DC annuitization.

- *Plan investment language.* The purchase of the annuity guarantee needs to be structured as a directed investment of the plan participant, as opposed to a benefit option under the plan. This is particularly the case if only longevity insurance is purchased, which goes into pay status after a participant's account balance is depleted. The plan's investment language should be drafted as broadly as possible both to accommodate the purchase of an annuity as an investment, and to allow various ways in which premiums can be paid. In particular, care should be taken to ensure that the plan language does not prevent the following programs:

  - *Single premium purchase.* Annuity guarantees can be purchased in a single, lump-sum premium (or a series of such

[7] Crawford and Beadles, *Law and the Life Insurance Contract* (Richard D. Irwin 1989).

[8] *Crouch on Insurance* 2d (Rev'd), §81:1.

[9] *SEC v. The Variable Annuity Life Insurance Co.*, 359 U.S. 5 (1959).

[10] *See, e.g.,* §414(i), (j).



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purchases) in anticipation of an immediate or deferred payout. This type of purchase is most likely to occur at the time the participant expects to begin drawing regular payments from the annuity held by the plan. It is also what would occur in an ''integrated'' program, where the annuity's design is closely integrated with the rest of the investments of the plan.

●● *Periodic premium purchase.* Some annuity products permit the plan participant to purchase small portions of a guarantee over a period of time, for example, with a portion of each payroll deposited to the DC plan.

●● *Combination equity/annuity programs.* Programs can be designed whereby mutual fund investments are used during a withdrawal period until such time as the account balance is depleted or a specific age is reached. At that time, a form of longevity insurance is triggered. Often times, because the insurance is keyed to hedging programs, the nature of the mutual fund investments made available are limited.

● *Other plan and administration issues.*

●● *Annuity features as part of the plan.* There will be within the annuity product a number of terms and conditions that will apply to those products but will not be contained in the plan document itself. There is no clear guidance as to whether, and to what extent, these features will be considered plan features that are includible in the document. There is a very real question about whether or not, then, a prototype plan will be able to support these contracts to the extent they are seen as adding plan features.

●● *Discrimination.* There may be restrictions on some of these products, such as minimum account values, that may raise the issue of the products being a ''Benefits, Right or Feature'' [11] that will be need to be tested for discrimination.

●● *Protected benefits.* Though it appears that the provision of an investment that provides an annuity benefit is not subject to §411(d)(6), a poorly drafted plan document may actually cause protected benefits issues.

●● *Reporting and disclosure.* The benefits must be valued, and payments from the contract must be reported, for Form 5500 purposes. This can be a challenge because the annuity contract will be typically administered as an ''outside asset'' of the plan.

●● *Required minimum distributions.* Because of the variety of different distribution options available under these products, care needs to be taken in their design to meet the required minimum distribution rules.[12]

● *Portability.* The most significant issue arising from providing guarantees from annuity contracts within is the issue of portability. It is of particular concern where a guarantee is accumulated over the years, or where the annuity is in pay status.

When the annuity contract is part of the plan, the ability to move the contract from the plan upon plan termination or a plan merger is critical. Such contracts must have the ability to be treated as Qualified Plan Distributed Annuity (QPDA), as described below. The choice to provide these benefits from within the plan is effectively a choice to make the contract, and the insurance company issuing the contract, an integral part of the plan for a potentially very long time.

## Issues from Distributing from Annuities Outside of the Plan

Distributing annuities from a plan raises much fewer issues than distributing from annuities within the plan. There are several insurance providers which have opted for this approach to avoid those complications. This includes the fact that a QPDA is no longer considered part of the employer's plan once it is distributed, and is generally no longer subject to ERISA.

[11] *See* Regs. §1.401(a)(4)-4.

[12] §401(a)(9).



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The distribution of annuities is accomplished by means of a QPDA.[13] This occurs whenever a participant's account balance is used to purchase an immediate or a deferred annuity, either at the time of distribution or through periodic purchases over time under the plan. The value of a QPDA is that it makes the insurance guarantees purchased under the plan ''portable,'' allowing the participant to take those purchased guarantees with him rather than having to leave them behind in the plan.

For plan language purposes, the QPDA is an in-kind, lump-sum distribution of an annuity contract, which should not be confused with the election of an ''annuity payment.'' The QPDA distribution can also be made under the normal terms of a plan document that permit lump-sum distributions (as long as the lump-sum distribution is not limited to a cash distribution), or can be made upon the termination of the plan, if the terms of the plan so allow. These distributed annuity contracts can have a cash surrender value, upon which the participant will not be taxed until withdrawn from the annuity.[14]

The legal basis for the Defined Contribution QPDA has existed for a long time: It is same basis that permits the distribution of annuities from a terminating defined benefit plan. What now makes the QPDA such an effective tool for DC plans is that it allows these plans to take advantage of the wide range of guarantees being developed by the market.

Because of its limited use in the DC market to date, QPDAs lacks much of a formal, governing regulatory structure. This means that there remains a bit of clarification needed on a number of rules. The IRS has suggested that all of the tax rules governing qualified plans will continue to apply to the QPDA, with the insurance company then necessarily fulfilling the role of plan administrator. Distribution of a QPDA is not a rollover and is not reported (nor treated for tax purposes) as such.[15] The QPDA is the payment of the balance to the credit of the employee for purposes of §402(c), and is treated as if it were a part of an ongoing plan.[16] As noted, taxation to the participant occurs only when, and to the extent that, payments are actually made from the contract.[17]

Specifically, the following handful of tax rules apply:

- The contract must be nonforfeitable and nontransferable.[18]
- QPDAs can accept rollovers from, and can roll their funds into, qualified plans, IRAs, and other QPDAs, and must provide for direct rollovers.[19]
- Any spousal rights and benefits under §§401(a)(11) and 417 that may have arisen under the distributing plan cannot be eliminated by the distribution of a QPDA.[20]
- The minimum distributions rules attributable to §401(a) plans apply to the QPDA, and the insurance company appears to have the affirmative duty to force the minimum distribution out of the contract.
- The distribution of the QPDA is reported on Form 1099-R, but no withholding is required as it is not a taxable event. The 20% withholding requirement applies to distributions from the QPDA in the same manner as if it were made from a qualified plan.
- The prohibited transaction rules under §4975 do not apply, as it is technically neither an IRA nor a ''plan.'' [21]
- There is no requirement of filing an annual report or registration on the Form 5500, nor a Form 5498, which is otherwise required for IRAs.
- The §402(f) notices (related to informing plan participants of the tax effect of the distributions) need not describe the tax effects of a QPDA.[22]

## KEY FIDUCIARY ISSUES ON DC ANNUITIZATION

While the decision to offer an annuity within a DC plan may be considered a settlor function, the choices of annuity provider and the annuity contract to provide benefit distributions from an individual account plan are fiduciary acts.

### Selection of an Annuity Provider

The selection of an annuity carrier is a difficult decision for plan fiduciaries and their advisors because

[13] Regs. §1.402(c)-2, Q&A-10(a).

[14] *See* Instructions for Forms 1099-R and 5498 at 10, available at http://www.irs.gov/pub/irs-pdf/i1099r.pdf.

[15] *See* Instructions for Forms 1099-R and 5498.

[16] GCM 39882 (5/27/92).

[17] Regs. §1.402(a)-1(a)(2).

[18] §401(g) (defining ''annuity''); *see also* Regs. §1.402(c)-2, Q&A-10(a).

[19] Regs. §1.402(c)-2, Q&A-10(b).

[20] Regs. §1.401(a)-20, Q&A-2.

[21] See definition of ''plan'' under §4975(e).

[22] Regs. §1.402(f)-1.




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of the insurer ‘‘solvency’’ risk. The fiduciary is called upon to make a judgment on whether or not the insurance company will be solvent long enough meet its lifelong obligations to plan participants. The DOL has attempted to address the issue. It first issued Advisory Opinion 2002-14A, under which it made it clear that the so-called ‘‘safest available annuity’’ rules under 29 CFR 2509.95-1 (or ‘‘Interpretive Bulletin 95-1, which was designed for annuity distributions from defined benefit plans) would apply to the selection of an annuity provider for distributions from defined contribution plans.

In response to concerns that the ‘‘safest available annuity’’ standard set too high a standard for the purchase of annuities on a regular basis from DC plans (where it seems to imply that there can be only one safest available annuity), Congress directed the DOL in the Pension Protection Act of 2006 to draft new regulations. These regulations were to clarify that the selection of an annuity contract as an optional form of distribution from an individual account plan is not subject to the safest available annuity standard under Interpretive Bulletin 95-1, and is otherwise subject to all otherwise applicable fiduciary standards.

The new regulation, 29 CFR 2550.404a-4, outlines safe harbor standards for fiduciaries to follow in selecting an annuity provider. The safe harbor is available 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 benefits and services to be provided under the contract; and

(5) If necessary, consults with an appropriate expert or experts.

The preamble to the regulations made several interesting points:

- An annuity provider’s ratings are not part of the safe harbor, though they are encouraged to be used. Ratings can be notoriously misleading for a variety of reasons.
- The preamble encourages plan sponsors to assess the protections that may be available through state guaranty associations, which provide a sort of insurance to policyholders in the case of the insolvency of an insurer. This is an imperfect system, and insurance companies are severally restricted by law from discussing this guarantee with their policyholders. Of this, the data needs to be accessed by the plan sponsors or their advisors. The best solution for the future may be the proposal for a sort of FDIC program for plan annuities, as described by the David John and Bill Gale of the Retirement Security Project.[23]
- Experts are not necessarily required to be used in the assessment.

As helpful as the safe harbor may be, it truly begs the question: How does a fiduciary get comfortable with the long-term insurer solvency risk? Pooling risks with others is an uncomfortable concept that is foreign to a fiduciary with a defined contribution mindset, as is an insurer’s insolvency risk.

The insurance solvency risk is one that has confronted the states for a very long time. The pooling of risk and the undertaking of this solvency risk are critical societal functions, but they pose significant risks to a state’s citizens whose policyholders are unable to address individually. Because of this, the states have uniformly stepped in to protect their citizenry by regulating insurance unlike any other industry:

- Reserves are required for the risks taken (one of the big AIG failures in the recent economic collapse was that large levels of risk were taken on without any reserving by a non-insurance subsidiary which was not governed by an insurance regulatory authority);
- The manner in which the reserves are invested are heavily regulated for investment risk and type under the risk-based capital rules;
- Insurance companies are regularly and comprehensively examined by state insurance authorities and must do substantial regular reporting on their assets and the nature of them.
- Insurance companies are required to participate in their state guarantee associations to protect the policyholders of all companies within the state.
- Review of marketing material of all insurance products is required, and insurance companies have the duty to supervise the activities of their agents.

[23] Its website can be found at http://www.brookings.edu/projects/retirementsecurity.aspx.



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Ultimately, an adequate fiduciary review would have the fiduciaries acknowledging that the task they undertake is different from the mere investment of account balances; the standard against which they will be judged has necessarily a stronger insolvency risk; and that they have addressed that risk adequately — in part — by understanding and relying upon the state's regulatory role in managing the risk. Essentially, the fiduciaries should have a ''pass'' on this risk, as long as the insurer is subject to participation in the various state guaranty associations.

## Selection of the Annuity Product

Selecting the annuity provider and dealing with the solvency issue is only the first step in the process. The design of the annuity product itself is also subject to fiduciary scrutiny.

A threshold question is the circumstances under which the QPDA will be subject to ERISA's fiduciary rules. It is clear that an individual annuity contract, once distributed by the plan, is no longer subject to ERISA if it is issued to the former participant.[24] However, it is not unusual for a participant to receive a ''certificate'' issued under a group annuity contract still held by a plan, instead of an individual annuity contract. The question is under what conditions will this ''certificate'' be considered subject to ERISA. The answer likely lies in the terms of the group annuity contract itself, and relies under the DOL's concept of looking to the ''ordinary notions of property law.'' Should authority under the certificate be exercisable under the group annuity contract held by the plan, there is a strong likelihood that the certificate would still be considered a plan asset. Should the group contract retain only nominal rights under the certificate, then there is a strong likelihood that the QPDA would not be considered a plan asset.

The following elements are also important to a fiduciary review of any particular annuity product:

- *Costs.* Check for annuity purchase rates, comparing what benefit is being purchased for what price. Many features that are provided can also be individually priced. Though ''fees'' are the typical focus of fiduciaries, that's not necessarily the proper inquiry for these sorts of annuities — it really is all about seeing how much benefit can be purchased for what price. Check commissions.
- *Expenses.* There is tremendous variation in the fees charged under an annuity contract for the package of financial services it provides. They may take the form of asset charges (called ''mortality and expense charges'' for registered products) if there is an account balance, as well as investment management fees. It is important to seek an explanation of contracts' expenses.
- *Annuitization assumptions.* Review the assumed interest rate (AIR) upon which the annuity payout is based, and find what percentage of the accumulated premium will be paid out annually.
- *General account crediting rate and restrictions.* If a guaranteed account is available under the contract, understand how the crediting rates are set and how often they are changed. Review any specific provisions related to the handling of these funds upon termination (including the crediting rate in case a ''stretch'' payment period is required).
- *Appropriateness for plans.* Make sure the annuity is designed for a retirement plan: Look for unisex mortality tables and, if there's a death benefit, that the incidental benefit rules are met.
- *Benefit sensitivity.* Determine whether there are any penalties or charges for ''normal'' retirement payments from the contract. Determine whether any surrender charges or market value adjustments are applied against amounts withdrawn from the contract in accordance with the terms of the plan.
- *Product harmonization.* Determine whether the annuity's withdrawal and transfer rules governing distributions from the contract are consistent with the terms of the plan document. This is important particularly in many of the forms of ''hybrid'' annuitizations and with living benefits, where an account balance is maintained along side an annuitization guarantee.
- *Advisor rules.* If participants are allowed a choice of annuities, if an advisor is used, or if any of products are registered products, make sure the advisor follows FINRA's suitability rules.
- *Portability.* Determine whether the contract can be transferred to the participant without additional charges in the event there a distribution of the annuity from the plan.
- *Reporting and disclosure.* Look for assurances that the insurance company has the ability to fully report the information needed to complete the Form 5500, including schedules A, C, H and I, and to comply with the Department of Labor regulations related to fee disclosure.

## DATE OF ANNUITIZATION; SPOUSAL CONSENT

The IRS issued a critical private letter ruling, wherein two key issues were addressed: the date an-

[24] *See* DOL Advisory Opinions 2003-05A (4/10/03) and 1999-08A (5/20/99) (citing ordinary notions of state property law in determining whether assets constitute plan assets).



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nuitization occurs under a QPDA, and when spousal consent is required.[25] Under the ruling, spousal consent is required at the time the participant elects to receive a lifetime payout, even if actual annuitization will be deferred for several years hence. Actual annuitization will occur when the payments supporting the benefit are derived directly from the insurer's own assets, not from those assets within a participant's separate accounts.

## SUMMARY

The above outlines key ERISA and tax code considerations involved in an employer considering to purchase annuities with §401(k) assets, It does not delve into a whole host of rules that need to be considered when developing or distributing these products, including certain security laws (which exist concurrently with ERISA), as well as other regulatory scheme involving the likes of FINRA, OFAC and others.

The rules will be quickly evolving as the Employee Benefit Security Administration and the IRS develop rules intended to make the purchase of annuities and other insurance guarantees simpler and much more effective.

[25] PLR 200951039.



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