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Retirement Planning

First Steps to Modernizing DC Annuitization: QLACs and Revenue Ruling 2012-3



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Recent guidance from the Treasury Department and Internal Revenue Service focuses on modernizing and streamlining the manner in which guaranteed lifetime income can be offered through defined contribution plans. The guidance is best viewed as a first installment of regulatory guidance on defined contribution plan annuitization.

A number of technical issues still need to be addressed. The initial guidance provides a foundation for addressing the additional concerns related to protected benefits, nondiscrimination rules, qualified domestic relations orders, and other plan administration issues. However, because the initial guidance answers several basic questions, longevity products can be developed and purchased with more certainty now.

The initial guidance takes the form of two proposed regulations: one that would permit qualified longevity annuity contracts (QLACs) and another that would modify the valuation rules related to partial annuitization from defined benefit plans;¹ and two new revenue

¹ 77 Fed. Reg. 5,451, 2/3/12.

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rulings: one that answers a basic question about annuity starting dates and another that provides guidance on rolling over amounts from qualified defined contribution plans to qualified defined benefit plans to purchase additional annuity income.²

This BNA Insights article discusses the technical application of the proposed QLAC regulation and the ruling on annuity starting dates. A related BNA Insights article by Paul M. Hamburger (61 PBD, 3/30/12) focuses on some of the legal issues related to the proposed QLAC rules and the guidance on rollovers from defined contribution plans to defined benefit plans.

QLAC Terminology

The term “qualified longevity annuity contract” would be new to the tax code. It refers to a type of annuity for which the premium, if paid from a qualified retirement plan or a traditional individual retirement account, would qualify for special treatment under the tax code’s required minimum distribution rules. Any amount used for a premium payment to purchase a QLAC under certain defined contribution plans and individual retirement accounts, within limits outlined in the proposed regulation, would be excluded from amounts used to compute annual required minimum distributions from those plans or IRAs.

The policy reason for granting relief from the required minimum distribution rules is stated in the preamble to the proposed regulation:

The Treasury Department and the IRS have concluded that there are substantial advantages to modifying the required minimum distribution rules in order to facilitate a participant’s purchase of a deferred annuity that is scheduled to commence at an advanced age—such as age 80 or 85—using a portion of his or her account. Under the proposed amendments to these rules, prior to annuitization, the participant would be permitted to exclude the value of a longevity annuity contract that meets certain requirements from the account balance used to determine required minimum distributions. Thus, a participant would never need to commence distributions from the annuity contract before the advanced age in order to satisfy the required minimum

² Rev. Ruls. 2012-3 and 2012-4.

distribution rules and, accordingly, the contract could be designed with a fixed annuity starting date at the advanced age and would not need to provide an option to accelerate commencement of the annuity.³

The proposed regulation (REG-115809-11) is part of a larger regulatory initiative targeting longevity risk, especially the risk that plan participants and beneficiaries will outlive the retirement savings in their defined contribution plan accounts and IRAs. By itself, the QLAC proposal might not have significant consequences for the provision of lifetime income, but paired with Rev. Rul. 2012-3, it could be a major building block of lifetime income.

The QLAC proposal provides incentives for plan participants to use any type of investment, including mutual funds, exchange-traded funds, or other noninsurance funds, to develop a cost-effective systematic withdrawal program, which can be used in tandem with lifetime guarantees payable at a time when a participant's account balance is expected to be exhausted.

Elements of a QLAC

A QLAC would be purchased exclusively through individual accounts in defined contribution plans described under tax code Sections 401(a), 403(b), or 457(b) for governmental plans or through traditional IRAs.⁴ The QLAC rules also would not apply to defined benefit plans or to in-plan Roth accounts or Roth IRAs.⁵

A QLAC would have the following characteristics:

1. *Insurance policy.* The QLAC would be an annuity issued by an insurance company licensed to do business in the trustee's state. Synthetic, or noninsurance programs that attempt to mimic insurance guarantees, would not qualify as QLACs.

2. *Fixed annuity.* The annuity contract could not be a variable annuity contract, equity-indexed contract, or similar contract with an equity component.⁶

3. *Terms of the annuity contract.* The QLAC would have these additional features:

a. It could accept premiums only up to the limitations described below.

b. Distributions would have to begin at a specified date that is no later than the first day of the month "coincident with or next following" the employee's 85th birthday, although it could be earlier.

³ *Id.*, fn. 2.

⁴ Because tax code Section 457(b) plans for nongovernmental tax-exempt organizations must be unfunded, the Section 401(a)(9) minimum distribution rules would not apply.

⁵ See Treas. Reg. § 1.408-8, Q&A 12(d) for the Roth IRA rules. Because tax code Section 401(a)(9) does not apply to Roth amounts in a plan, the QLAC rules would not apply to such amounts. However, the proposed regulation would not prevent in-plan Roth funds from being used to purchase longevity insurance. Treasury requested comments on whether the regulation should be modified to apply the QLAC rules to Roth IRAs or to reduce the availability of Section 401(a)(9) relief for purchasing QLACs by the amount of assets that an individual holds in a Roth IRA. Treasury also has requested comments on whether any special rules should apply when a QLAC is purchased with assets from a Roth IRA.

⁶ Treas. Reg. § 1.401(a)(9)-6, Q&A-17(a).

c. Payments from the contract would have to satisfy the required minimum distribution rules for annuities.

d. Payments would be nonforfeitable and could not be surrendered or commuted, even for a cash surrender value, which means that term-type annuities, even if otherwise permissible under plans, would not qualify for QLAC treatment.

e. No death benefit would be permissible other than payment of a life annuity in accordance with terms of the proposed regulation. The periodic payments continuing to a beneficiary after death could not exceed 100 percent of the periodic payment otherwise payable to the participant. Exceptions would be allowed for spousal payments that, because of qualified preretirement survivor annuity rules, result in larger payments. The QLAC would be required to have special tables for nonspousal annuity payments.

f. A QLAC must be specifically identified as a QLAC.⁷

4. *Limitations.* The limit on premium amounts used to purchase a QLAC would be an individual limit for all IRAs and plans in which a person participates. It would be the excess of 25 percent of the participant's account balance over the sum of all other premiums a participant paid for the QLAC under that plan or any other plan or IRA,⁸ not to exceed \$100,000. Failure to comply with the dollar limitation or age limitation would cause the contract to lose its QLAC status as of the date of the failure, and the premium paid for it could not be excluded from the minimum distribution calculations.⁹

Treasury does not view the prescribed limit as an insubstantial limit. It assumes that, for a participant at age 70 who uses \$100,000 of his or her account balance to purchase an annuity that would commence payments at age 85, the annuity would provide annual income of \$26,000 to \$42,000.

Disclosure and Annual Reporting

Disclosure. The QLAC disclosure and reporting rules that would be required under the proposed regulation would introduce a new concept into qualified plan administration. The *issuer* of an investment product under a plan, not the plan administrator, would be the entity required to disclose and report to plan participants the following information:

1. a plain-language description of the dollar and percentage limitations on premiums;

2. the annuity starting date under the contract and, if applicable, a description of the employee's ability to elect to commence payments before the annuity starting date;

3. the amount or estimated amount of the periodic annuity payment that is payable after the annuity start-

⁷ Treas. Reg. § 1.401(a)(9)-6, Q&A-17(a)1-6.

⁸ A plan would be permitted to rely on written representations of participants in applying the limit, unless the administrator had specific knowledge otherwise. Treas. Reg. §§ 1.401(a)(9)-6, Q&A 12(d)(1); 1.403(b)-6(e)(9); 1.408-8, Q&A 12(c).

⁹ Treas. Reg. § 1.401(a)(9)-6, Q&A-17(d)(2).

ing date as a single-life annuity; if an estimated amount, the assumed interest rate or rates used in making this determination; and a statement that there is no commutation benefit or right to surrender the contract to receive its cash value;

4. a statement of any annuity death benefit payable under the contract, including any differences between benefits payable if the employee dies before the annuity starting date and benefits payable if the employee dies on or after the annuity starting date;

5. a description of the administrative procedures associated with an employee's elections under the contract, including deadlines, how to obtain forms, where to file forms, and the identity and contact information of a person from whom the employee may obtain additional information about the contract; and

6. additional information that the IRS commissioner may require.

This information, on which Treasury has requested comments, would be furnished before or at the time the QLAC is purchased. To avoid duplicating state law disclosure requirements, the issuer would not be required to include in the report any information that the issuer has already provided to the employee for satisfying applicable state disclosure laws.

There would be no requirement to file the report with IRS.

Annual Reporting. The proposed regulation also prescribes annual reporting requirements under tax code Section 6047(d). The proposal would require the QLAC issuer, and not the plan administrator, to file annual calendar-year reports with IRS and to provide the person, in whose name the contract was purchased, a statement about the status of the contract. The statement would be provided on a form to be developed by IRS.

The form would state that the contract is intended to be a QLAC and would include, at a minimum, the following items of information:

1. name, address, and identifying number of the issuer of the contract, along with information on how to contact the issuer for more information about the contract;

2. name, address, and identifying number of the individual in whose name the contract was purchased;

3. if the contract were purchased under a plan, the name of the plan, the plan number, and the Employer Identification Number (EIN) of the plan sponsor;

4. if payments have not yet commenced, the annuity starting date on which the annuity is scheduled to commence, the amount of the periodic annuity payable on that date, and whether that date may be accelerated; and

5. the amount of the premium paid for the contract, along with the payment date.

The form that would be provided to the participant would include the words: This information is being furnished to the Internal Revenue Service. Under the proposed regulation, the QLAC issuers would be required to furnish the form annually until payments under the contract commence or the participant dies without a beneficiary.

QLAC Administration

The QLAC would fit within the regulatory scheme that applies to qualified plans and IRAs. A purchased annuity would become an asset of the plan or IRA. As part of a plan, the QLAC would be an "in-kind" investment of the plan and an asset of a plan participant's individual account.

As part of an IRA, a QLAC apparently could be either an asset of an individual retirement account under tax code Section 408(a) or be part of an individual retirement annuity contract under Section 408(b), assuming the purchase meets the QLAC requirements described below. It would also appear that the annuity product could be designed by the insurer as a separate Section 408(b) IRA and purchased with a nontaxable transfer or rollover from another IRA or qualified retirement plan.

The rules that apply to qualified plans, including 403(b) and 457(b) plans, and to IRAs with respect to annuities as investments would apply to QLACs. For example:

The insurer issuing the QLAC would be a service provider subject to fee disclosures under Section 408(b)(2) of the Employee Retirement Income Security Act.

- The QLAC would be a designated investment alternative subject to disclosure according to annuity disclosure rules under DOL Reg. § 2550.404a-5, although the plan document itself might not need to specifically authorize QLACs.

- Even though the QLAC would be treated as an individual account investment and not as a benefit structure under the plan, the spousal rights rules of the plan would still apply. Therefore, spousal consent would be required if the QLAC were purchased in a form other than that of a qualified joint and survivor annuity because it would be an irrevocable election of payment as an annuity.

- The purchase and holding of a QLAC by a qualified plan or IRA would be subject to prohibited transaction rules under the tax code and ERISA, to the extent applicable.

- The QLAC could be distributed as a nontaxable distribution from a qualified plan or IRA,¹⁰ and the contract could be rolled over between plans and IRAs in accordance with applicable rollover rules.¹¹

This article is not an exhaustive description of how technical rules for qualified plans and IRAs would apply to QLACs. For example, it does not detail special requirements for applying the QLAC rules to Section 403(b) plans, and clarification would be necessary in several areas if the proposed rules become final. However, the proposed QLAC regulation is generally well coordinated with Rev. Rul. 2012-3 and is a good example of how the revenue ruling can be applied.

Revenue Ruling 2012-3

IRS issued Rev. Rul. 2012-3 at the same time as Treasury issued the proposed QLAC regulation discussed

¹⁰ Treas. Reg. § 1.408-4(e) for IRAs; Treas. Reg. § 1.402(a)-1(a)(2) for Section 401(a) plans. It would appear that a stand-alone distribution of a QLAC from a Section 403(b) plan might not be workable under the 403(b) rules.

¹¹ Treas. Reg. § 1.401(a)(31)-1 Q&A 17.

above. The revenue ruling verifies the application of qualified joint and survivor annuity (QJSA) and qualified preretirement survivor annuity (QPSA) rules, as described in tax code Sections 401(a)(11) and 417, to deferred annuity contracts purchased under profit-sharing plans. The ruling also provides a method for determining an “annuity starting date” for annuities purchased through qualified plans.

Determining the annuity starting date is critical because compliance with the QJSA and required minimum distribution rules, and their related notice and consent requirements, hinges on that date. Without knowing the annuity starting date, plan administrators would be unable to administer QJSAs, QPSAs, or QLACs with any consistency. Plan administrators could not administer the rules properly or delegate responsibility for administering the rules to insurance companies after the annuities were purchased.

Rev. Rul. 2012-3 also has broader consequences. It establishes, in light of the QLAC rules described above, a basis for treating an annuity option in a defined contribution plan as an investment option and not as a benefit structure under the plan.

Annuity Starting Date. IRS issued two private letter rulings in the past several years¹² that seemed to take conflicting positions on when an annuity starting date occurs. At issue in those PLRs was how the spousal consent rules apply to hybrid annuities of the sort that is becoming widely available in the Section 401(k) plan marketplace. These hybrid products guarantee lifetime income but also maintain a participant account balance invested in equities. The products tend to have complex designs that generally permit participants to withdraw amounts from their account balances throughout their lifetimes and provide “longevity insurance” payments at a guaranteed level if the account balances are depleted or the participants reach a certain age.

IRS was asked for a ruling on whether electing and beginning a flow of withdrawals from an account balance at actuarially determined levels, where the actual “insurance” does not kick in for a number of years, constitutes amounts payable in the form of an annuity.¹³

IRS first answered the question in 2009 when it ruled, in PLR 200951039, that the initial election related to a longevity insurance product described in the private ruling was legally two elections. The first was an election to take “payments as an annuity” at a later date when “insurance payments” arising from the longevity insurance kicked in, triggering the application of the Section 417 rules. The second was an election to take “payments not as an annuity” for any payment before the longevity insurance payment starting date.

In a second private ruling, PLR 201048044, IRS apparently shifted from its earlier position when it ruled that an initial distribution election characterizes all periodic payments from a contract as “payments as an annuity,” beginning with the first payment. The ruling held that this is so even when all payments are withdrawals from an account balance that reduce the account balance.

Rev. Rul. 2012-3 seems to have resolved an apparent conflict in the private letter rulings. Rev. Rul. 2012-3 describes three situations to demonstrate how the annuity starting date rules apply.

In Situation 1, a participant invests in a typical group variable annuity contract for which the default distribution when the participant reaches age 65 is an annuity.¹⁴

In Situation 2, the participant invests in a fixed annuity that will start at age 65, for which no amounts may be transferred out of the contract, and the only death benefit is a survivor annuity.¹⁵

In Situation 3, the participant invests matching money in a 100 percent single-life annuity starting at age 65. The annuity will pay no death benefit even if death occurs before the annuity starting date.¹⁶

Based on those three situations, IRS makes the following holdings in Rev. Rul. 2012-3:

1. If an annuity contract has a stated default annuity starting date that can be “defeated” by an election to accelerate payments, to surrender the contract, to withdraw the contract’s value, or to transfer assets in the contract to other plan investments, the mere existence of a default date does not make an annuity the normal form of benefit under the plan. This means that, absent

¹⁴ *Situation 1.* This situation describes a typical Section 401(k) arrangement funded with a variable group annuity contract, except the default payment at age 65 will be, if no other form is elected, an annuity to which the QJSA rules apply. The annuity contract provides for annuity payments beginning at age 65. The payment amounts are determined at that time, based on the account balance in the contract and on actuarial assumptions, including interest rate and mortality assumptions, that determine the annuity purchase rate on that date. The annuity purchase rate also is subject to a minimum-purchase-rate guarantee set forth in the contract.

A participant in a profit-sharing plan contributes to the annuity as an investment under the plan, investing portions of his elective deferral and matching contribution amounts in the deferred annuity contract on various dates, beginning on a date when the participant is age 45 and ending on a date when the participant is age 65. At any time before the later date, the participant can elect a single sum payment, which, according to the analysis, can include money transfers out of the contract into other investments within the plan. The death benefit under the contract, before the annuity starting date, is the account balance. The participant retires at age 65.

The annuity starting date for the participant under the deferred annuity contract in that situation is the first day of the month after he retires.

¹⁵ *Situation 2.* The facts are same as in Situation 1, but the contract is substantially different. The investment is in a fixed annuity contract, and the participant may not subsequently transfer amounts out of the contract, may not elect to take amounts in the form of single-sum payments, and may not transfer amounts to other investments within the plan. The amounts invested in the deferred annuity contract will be paid in the form of a life annuity. The amount payable under the deferred annuity contract is based on the amount invested in the contract on the date the investment is made and on actuarial assumptions, including interest rate and mortality assumptions, used to determine the annuity purchase rate on that date.

¹⁶ *Situation 3.* The facts are the same as in Situation 1, but the participant who invests amounts in a deferred annuity contract may elect irrevocably to have the matching contributions pay for an annuity that has no benefits payable, even on death, before the annuity starting date. If the participant makes this election, the participant’s spouse, if any, must give notarized consent to the election.

¹² PLR 200951039, Sept. 21, 2009; PLR 201048044, Sept. 9, 2010.

¹³ 26 U.S.C. § 417(f)(2)(A)(ii).

an affirmative election, the mere existence of a default starting date does not cause a plan to lose its profit-sharing plan exemption from the QJSA rules, provided a spouse is the beneficiary, or has the right to consent to someone else being the beneficiary, of any cash value under the contract. Thus, in Situation 1, the QJSA rules do not apply to withdrawals from the contract made before the participant is age 65.

2. The default date (age 65 in Situation 1) becomes the annuity starting date for amounts in the contract at age 65, which means the notice and consent periods under tax code Section 417 are tied to (in Situation 1) the date the participant turns 65.

3. The date under the contract that an annuity form of payment cannot be “defeated” by acceleration, withdrawal, or surrender is the date that an annuity form of benefit will be considered as having been elected. In Situation 2 and 3, this “election” occurs as of the date of purchase because the annuity is effectively irrevocable, and the contracts become subject to the QJSA and QPSA rules. This point is highlighted in Situation 3, where spousal consent is required to elect a 100 percent single-life annuity with no QPSA.

4. The QJSA and QPSA rules, when they do apply, apply only to the contracts in the participant’s account. The remainder of the plan, including the remainder of the participant accounts, are not subject to these rules unless, and to the extent, annuities are purchased.

A QLAC’s election date is the date it is purchased. The annuity is irrevocable, the starting date cannot be accelerated after its purchase, nor can there be a withdrawal or surrender for a cash value.

Conclusions: Rev. Rul. 2012-3 and QLAC Administration

The recent guidance from IRS and Treasury has important implications for plan administration and product development beyond the specific holdings. Those implications are summarized here:

1. Lifetime Income as an Investment. The proposed QLAC regulation and Rev. Rul. 2012-3 together confirm a crucial analysis: An annuity contract can be treated as a plan investment rather than as a benefit structure. The distinction is important because it permits annuities to take a variety of forms under a plan’s investment rules, including forms based on an accumulation of lifetime income rights, for example, or the purchase of deferred annuities to be distributed at the time of separation from service or held within the plan and paid out over time. Because distributions are paid out under the terms of the underlying annuity contract rather than under the terms of the plan document, major complications are avoided that would otherwise arise from efforts to include appropriate annuity language in the document’s benefit structure. Instead, the plan document can provide general plan language concerning investment authority and in-kind distributions.

2. Spousal Rights. Although an annuity purchase may be an investment and not a benefit, Rev. Rul. 2012-3 and the proposed QLAC clarify that spousal rights would still apply on distribution of funds from the annuity, even if the annuity is distributed from the plan. The guidance also describes the manner in which those rights would be enforced.

3. Annuity Administration. The guidance effectively sets the stage, under standard DOL and state contract rules, for the “nervous administrator” of a plan to delegate to annuity companies the role of administrator. There may be a number of insurance products under which it is yet unclear how the guidance would apply to the terms of specific products, but at least there are “stakes in the ground” from which to make such determinations.

4. Portability. Portability is a problem when plans provide income guarantees from defined contribution plans. How should those guarantees be handled when a plan terminates or there is a falling out between a plan sponsor and an insurer? To the extent that the IRS guidance announced in February supports the concept that the distribution of an annuity is an in-kind distribution from the plan, it sets the stage for a variety of potential solutions to the portability problem.