CHAPTER 13

Regulatory and Fiduciary Framework for Providing Lifetime Income from Defined Contribution Plans

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§ 13.01 BACKGROUND

With Defined Benefit retirement programs in a well documented state of decline, there are increasing public policy concerns about the manner in which lifetime income guarantees are going to be provided to a retiree workforce.[1] Once the mainstay of the private retirement system, nearly 70% of all private retirement plan participants benefited under Defined Benefit (DB) plans in 1975. In 2010, only 27% of plan all participants in private plans were covered by these plans, with 73% being covered by Defined Contribution (DC) plans.[2] Both the regulatory framework governing retirement plans and the product marketplace are in transition to address these changes.

This dramatic shift to DC plans has served to shift substantial risks to plan participants, jeopardizing retirement security. The Government Accountability Office (GAO) published a study in 2009[3] which identified these risks as being longevity, inflation, and investment risks.

Employers in the past have traditionally relied upon the concept that asset accumulation and lifetime payouts as separate functions that cannot be combined into a single program, and that must be maintained under multiple, separate plans. This means that employers wanting to provide a lifetime income stream which the employee cannot outlive had to provide that benefit under a DB plan, with (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

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[1] *See*, for example, the EBSA and IRS *"Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans,"* 75 Fed Reg 5253 (Feb 2, 2010); and the papers written since 2004 by the Brookings Institution's Retirement Security Project, at http://www.brookings.edu/about/projects/retirementsecurity/research.

[2] Private Pension Plan Bulletin Historical Tables and Graphs, U.S. Department of Labor Employee Benefits Security Administration, November 2012.

[3] *"Private Pensions: Alternative Approaches Could Address Retirement Risks Faced by Workers but Pose Trade-offs,"* (2009) The Government Accountability Office. This report may be accessed at http://www.gao.gov/ new.items/d09642.pdf.

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," under which both a DC and DB plan are combined into a single plan document, is still effectively treated as two different plans. With employers demonstrating an aversion to DB plans, opting instead for DC plans or cash balance DB plans, this prior "two plan" approach is now failing, and at cost of retirement security.

The marketplace is responding to these circumstances through the development of a new generation of retirement annuities, outside of retirement plans, which are designed to alleviate what has been found to be consumers' fears related to the purchase of annuities.[4] This new generation of annuities attempts to combine the best features of traditional income annuities with those that protect and enhance the value of the assets accumulated under the annuity. The features include things like traditional longevity insurance; guaranteed withdrawal benefits; and guaranteed accumulation benefits. Depending on the product, the policyholder can purchase protections on a benefit "floor;" lock in investment gains over a period of time; or have their annuity payout vary with the investment performance of an underlying pool of funds. Insurers are now attempting to accommodate these types of products to the DC marketplace.

At the same time, the United States Departments of Treasury and Labor have also engaged in a significant policy initiative to attempt to address this systemic weakness in the provision of adequate retirement income through employment based programs. One of the key elements in this policy initiative is to explore the manner in which retirement income can be effectively provided through DC plans. Treasury and Labor held joint hearings[5] to collect information how to address this need; the IRS issued Revenue Ruling 2012-03,[6] to provide basic guidance on providing lifetime income from retirement plans; Treasury issued regulations to encourage the use of annuities from DC Plans and IRAs;[7] and the DOL issued "safe harbor" guidance on the selection

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[4] This aversion is well described in *"Why Don't the People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle,"* by Jeffrey R. Brown, University of Illinois at Urbana-Champaign and NBER; Jeffrey R. Kling, The Brookings Institution and NBER; Sendhil Mullainathan Harvard University and NBER; and Marian V. Wrobel Harvard University. January 2008, American Economic Review Papers and Proceedings 98:2 (2008). It can be found at http://users.nber.org/~kling/framing.pdf.

[5] "Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans," 75 Fed Reg 5253 (Feb 2, 2010). The comments and testimony related to those hearings can be found at http://www.dol.gov/ebsa/regs/cmt-1210-AB33.html.

[6] Rev Rul 2012-03, 2012-8 IRB 383.

[7] Prop Treas Reg 1.401(a)(9)-5, 77 Fed Reg 5443 (Feb 12, 2012).

of an annuity provider for defined contribution plans[8] and an advance notice of proposed rulemaking regarding the required disclosure of lifetime income equivalents on participants' DC statements.[9]

Note that many of these rules will be applicable to 403(b) plans in different ways, a discussion which is beyond the scope of this article.

§ 13.02 THE LEGAL FRAMEWORK FOR DC LIFETIME INCOME

[1] Generally

There already exists a substantial body of law related to the provision of lifetime income from insurance products purchased by retirement plans, though such guidance has generally been not widely published. In particular, section 403(b) plans (a form of DC plan) have been providing tax deferred annuities to plan participants since the founding of the Teachers Annuity and Insurance Association ("TIAA") since its founding in 1918 (under provisions that pre-dated the enactment of section 403(b)), and the distribution of annuities has been a normal practice under terminating defined benefit plans since their inception. There also has been substantial litigation relating to the purchase of annuities under retirement plans which serve well to inform the fiduciary requirements for the purchase of annuities for defined contribution plans today.

One of the drivers behind the push for increasing the provision of lifetime income from DC plans are recent innovations in the annuity marketplace. Much of it driven by technology, insurers have developed sophisticated income products which provide a number of guarantees beyond traditional annuitization. These guarantees are designed to alleviate the fears that often accompany the purchase of traditional annuity products, where purchasers give up control of their funds and their opportunity for equity exposure in return for a promised level of lifetime income. Complex hedging strategies now allow insurers to sell annuities which give purchasers some measure of control and some exposure to the equity marketplace, while insuring the downsides to those risks.

These, as well as income annuity products, have become popular-particularly in the IRA rollover market.[10] The challenge for regulators and insurers is to find ways to integrate not only traditional annuities into DC plans, but also permit innovative

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[8] 29 CFR § 2550.404a-4 (2008).

[9] 78 Fed Reg 26,727 (May 8, 2013).

[10] For example, Prudential reported in its response to the RFI (*see* fn 5) that 89% of those purchasing rollover products in its book of business elected income annuities. See also the report of the *Insured Retirement Institute*, March 27, 2013. Found at http://www.irionline.org/uploads/navaorg/news/722/original/q4_and_ye12_sales_report_final.pdf.

products such as those described above into DC plans, and doing it in such a way which preserves important participant protections.

The following paper organizes the "old" and the "new" in comprehensively describing the framework by which lifetime income can be provided through DC plans, demonstrating that annuitization is now generally available to DC plans under existing guidance. It is written with "flexibility" in mind, knowing that the structural framework for DC lifetime income needs to be able to accommodate a wide variety of guarantees and features as well. What we find is, though more guidance is necessary in order to accommodate the wide variety of types of annuity products that currently exist and that will be developed, and that care should be taken when designing a lifetime income within a DC plan, it is possible to properly provide lifetime income through DC plans under current law. Though the current regulatory and legal structure cannot support all of the types of products coming to market, the current rules can support a number of them as well as traditional annuitization.

[2] DC Qualification Issues Related to Lifetime Income Distributions from Within the Plan

A plan sponsor may choose to distribute retirement income from within the plan as a matter of plan design. Distribution of guaranteed lifetime income from within a DC plan can only be accomplished, however, through a purchase by the plan of insurance contracts by the plan's individual accounts. Though other, non-insurance vehicles may be able to provide systematic withdrawals designed to provide a steady stream for the anticipated lifetime of the participant, only insurance companies can provide the guarantee of income once the amount in the participant's accounts runs out. The DC plan has no other assets by which to otherwise provide funds to guarantee lifetime income payments, and therefore cannot itself be guarantor of the benefit. It has no right to demand funding for such benefit from the plan sponsor, as under a DB plan.

A plan's terms and operations must able to accommodate the insurance purchase and payout. There are several key plan issues which come into play.

1.Annuity as an investment under the plan. The purchase of the annuity guarantee should be structured as a directed investment of the plan participant, as opposed to a payout benefit option under the plan, and the plan language should reflect this status. This approach was affirmed in Revenue Ruling 2012-3[11] and under the proposed regulations for the Qualified Longevity Annuity contracts.[12] This distinction is important because it permits annuities to take a variety of forms under a plan's investment rules. This would include, for example, the purchase (as an investment) of annuity contracts with a variety of innovative features which may include investment

[11] Rev Rul 2012-03, 2012-8 IRB 383.

[12] Prop Treas Reg 1.401(a)(9)-5, 77 Fed Reg 5443 (Feb 12, 2012).

accounts within the annuity contract itself, or guarantees other than lifetime income guarantees.

Drafting a plan in this manner is a significant departure from traditional drafting practice, where annuity payments from a plan were actually reflected in the terms of the plan document itself and considered solely as payout options. In this case, however, the terms of the annuity contract are incorporated into the plan itself and will be viewed as terms governing the underlying investment. Because distributions are treated as payouts from the investments, 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 language that authorizes the use of the annuities as investment options. The plan's investment language should be drafted as broadly as possible to accommodate the purchase of varieties of annuities. The existing language in many plan documents, particularly of the "mass submitter" types, may already provide the broad authorization to do make such purchases, though it would be a sound practice to develop specific language over time.

2.Spousal rights. Providing annuitization from DC plans re-introduces a concept that these plans have largely moved away from over the years: the rules governing the Qualified Joint and Survivor Annuities and Qualified Pre-retirement Survivor Annuities (together the "J&S" rules). These rules provide spouses with a right to a portion of the benefit accrued under the plan and require timely notice to spouses and the spouse's consent should a distribution from a plan covered by the J&S rules be made other than in the form of a qualified joint and survivor annuity. This means, for example, that even a partial lump sum distribution from the plan would require spousal consent should the plan be covered by these rules. The DC marketplace has come to rely heavily on the fact that such notice and consent is not needed under the traditional DC plan design, where the only spousal right is that to be named the beneficiary to the accrued benefit upon the death of the plan participant.

There had been some confusion over how the J&S rules apply when a DC plan purchases annuities, with the IRS issuing two private letter rulings each reaching a different conclusion in the application of those rules.[13] The IRS clarified this when it issued Revenue Ruling 2012-03 which provided clear guidance on the manner in which the J&S rules apply to DC plans when purchasing annuities, and when it applied its guidance under the proposed QLAC regulations. As explained under Revenue Ruling 2012-03, the making available under the DC plan of an annuity investment does not, in itself, subject the plan generally to J&S Rules under Sections 401(a)(11) and 417 of the internal Revenue Code ("Code").

[13] *See* PLR 200951039 (2009) and PLR 201048044 (2010) where the IRS made conflicting decisions on when the J&S rules would apply to DC plans purchasing annuities.

Revenue Ruling 2012-3 clarified that spousal rights under IRC §§ 401(a)(11) and 417 would apply to the portion of the account balance which is used to purchase the annuity.[14] The Service ruled that the purchase of an annuity as an investment, however, would not trigger the application of the J&S notice and consent rules until such time as lifetime annuity payments became irrevocable under the contract. This means that if the plan is properly designed, participants can maintain account balances in those annuity contracts within the plan, or otherwise surrender the purchased contract for its surrender value, without spousal consent. The spousal beneficiary rules do continue to apply to the rest of the account, as well to the annuity before the annuity becomes irrevocable.

Many of these annuity contracts will contain a "default date," meaning that annuitization will occur at a specific date in the future unless the participant affirmatively opts out. The IRS also clarified in Revenue Ruling 2012-3 that the presence of this date, alone, does not constitute an election to make the annuity payment irrevocable, and the J&S rules will not apply.

These rules will not apply to the portion of the account balance not used to purchase an annuity.

Under IRC § 401(a)(11)(B), if a defined contribution plan separately accounts for assets (and related income) that are transferred from a plan that is subject to the J&S requirements (which would apply to a plan to the extent that an annuity was purchased), then that annuity (and related income) which is distributed from the plan is subject still subject to the J&S requirements.

3.Annuity starting date. The determination of the annuity starting date of any particular annuity product purchased by the plan is required in order to determine when the spousal notice and consent rules will apply to distributions from that product. This is because many of the types of annuities which can be purchased by plans have a variety of different designs which provide account balances which are held in investment accounts and permit a surrender of the contract, and for that surrender value to be transferred to other investments within the plan. Some annuity designs permit the surrender of the contract for value, a subsequent transfer to another investment account within a plan, even if there is no investment account in the annuity. Revenue Ruling 2012-3 set out the rule for determining the annuity starting date for these products, and the time when the J&S rules apply. The annuity starting date is the date that guaranteed annuity payments from the contract irrevocably begin. So, for example, if at any time a participant can surrender the annuity contract under the plan, or make a withdrawal from its account balances, it will not be considered as yet having an annuity starting date. On the other hand, if a contract sets a date where the

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[14] *See also* Treas Reg § 1.401(a)-20, Q&A2, and Treas Reg § 1.401-9, Examples 3 & 4.

guaranteed lifetime income payments are to begin (such as under a QLAC) or the participant irrevocably elects such a date, the spouse is then entitled to a notice, and consent is required, if those irrevocable payments are going to be made in a form other than a Qualified Joint and Survivor Annuity.

4.Discrimination. A plan cannot discriminate in favor of highly compensated employees, and there are a series of tests that a plan must pass to demonstrate that it in non-discriminatory. These tests look at plan coverage, benefits, and rights and features under the plan. Insurance companies which sell certain annuity benefits to DC plans may place restrictions on some of their products, such as minimum account values. Because this annuity would not be uniformly available to all participants in the plan, it will be considered a "Benefits, Right or Feature"[15] under IRC § 401(a)4 which will be need to be tested for discrimination.

5.Protected benefits. Poor plan drafting could cause a DC plan which purchases annuities to potentially violate the "protected benefits rule under IRC § 411(d)(6) when and if annuity carriers are changed under the Plan. This would happen if the plan drafted the distribution options under the annuity contract right into the plan document itself. Because each annuity potential contains different annuity options, the changing of the distribution option which may occur by virtue of the change in carrier may cause certain protected benefits to no longer be offered under the plan. Though it appears that the provision of an investment that provides an annuity benefit is generally not subject to the protected benefits rules under IRC § 411(d)(6), a poorly drafted plan document may actually cause these protected benefits issues.

6.Reporting and disclosure. The value of the annuity contract purchased under the DC plan must be determined, and payments from the contract must be reported, for Form 5500 purposes. This can be a challenge for service providers and plan sponsors because the annuity contract will be typically administered as an "outside asset" of the plan, and subject to special efforts to collect and report that information. The annuity is also subject to reporting under the ERISA Section 408(b)(2) reporting requirements,[16] as well as ERISA participant investment reporting rules.[17] This means that the plan sponsor should contract with its insurer, when making the annuity purchase, to provide all of the required disclosures and information necessary to operate the plan. The plan should consider not purchasing the annuity should these assurance not be given.

7.Required minimum distributions. Except if the annuity contract is a Qualified

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[15] Treas Reg § 1.401(a)4-4.

[16] 29 CFR § 408b-2.

[17] 29 CFR § 2550.404a-5.

Longevity Annuity Contract[18] (which, when the regulations are finalized, will exempt up to $100,000 of the purchase price of certain annuities to be exempt from the required minimum distribution calculations under a plan), the value of the annuity contract must be taken into account into determining the required minimum distribution to be made under the plan.[19] 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.

8.Allocation of Purchase Price. The purchase of an annuity based upon the life of a participant may involve, to some extent, the forfeiture of some portion of a benefit upon an early death of the participant. This can cause a problem under a 401(k) plan, under which elective deferrals are required to be nonforfeitable.

Revenue Ruling 2012-3 clarified the use of regulation 1.401(a)-20, Q&A-20 under such circumstances. A DC plan with a IRC § 411(a)(3)(A) forfeiture provision may not use more than a proportional percent of the account balance attributable to contributions that may not be forfeited at death (such as elective deferrals) to satisfy the J&S benefit. Thus, for example, where a participant's date-of-death account balance comprises 60% attributable to elective deferrals and 40% attributable to matching contributions, the maximum portion of a QPSA that can consist of amounts attributable to elective deferrals is 60%.

9.Portability. One of the most significant issues arising from providing guarantees from annuity contracts within the plan is the issue of portability. When the annuity contract is part of the plan, it is necessary to have the ability to move the contract from the plan upon plan termination or a plan merger. Such contracts must have the ability to be treated as Qualified Plan Distributed Annuity (QPDA), as described below.

This becomes a particular issue when the annuity being offered is designed to purchase a small lifetime benefit with each payroll deposit, or to otherwise accumulate an income guarantee over time. Care should be taken not to include the right to these guaranteed benefits in the body of the document, and that the investment language is sufficiently flexible to accommodate these products. 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. It is important that such products allow for a way to properly unwind the contract from the plan should the relationship with the insurer sour.

It also becomes an issue when mapping annuity guarantees from one carrier to another within the plan when the plan's fiduciary decides to change carriers. In particular, the fiduciary need to consider the surrender charge and other expenses

[18] Prop Treas Reg 1.401(a)(9)-5, 77 Fed Reg 5443 (Feb 12, 2012).

[19] Treas Reg § 1.401(a)(9)-6, Q&A-4.

which will be incurred when changing from one carrier to another, as well as the benefits which may be lost in such change.

[3] Annuity Contract Distributions from the Plan, the Qualified Plan Distributed Annuity

An employer may choose to offer to its employees the right to purchase an annuity, and to have that annuity then distributed to that participant when that participant is otherwise eligible under the terms of the plan for a distribution. These annuities are referred to as Qualified Plan Distributed Annuities (QPDA).[20] They can be used to purchase annuities at the time of distribution, or can be used to distribute an annuity which was earlier purchased under the terms of a plan.

<u>1.General nature of a QPDA.</u> The QPDA is a hybrid type of product from the IRS's point of view, looking like a combination of an IRA and a qualified plan-while being neither. The key, discerning element to these products is the lack of continued employer involvement or responsibility for proper ongoing administration of the annuity. The distribution of an annuity upon the termination of a DB plan is a QPDA; and it is these same rules which serve as the basis for the distribution of an annuity from a DC plan.

A QPDA is an annuity contract purchased for a participant, and distributed to the participant as an in-kind distribution[21] as part of the balance to the credit of the employee.[22] The annuity contract which is purchased by the plan and distributed to the participant does not have to be what is called an "immediate annuity," that is, it does not need to provide for the immediate payment of lifetime benefits. The annuity contract can have a cash surrender value, upon which the participant will not be taxed until withdrawal from the annuity.[23] This is basic feature of these products, as many annuity contracts being designed for DC plans carry account balances held in investment accounts from which that former participant can make periodic, non-annuitized withdrawals. This means that such contracts with variable investment accounts can qualify as a QPDA, even without any payments being immediately payable from the contract.

The distribution of a QPDA should not to be confused with the election of an "annuity payment." An annuity payment distribution option from a plan (instead of the lump sum payment of a QPDA) which was discussed in the prior section provides for periodic payments from the investment in the annuity form the plan; it is not the

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[20] Treas Reg § 1.402(a)-1(a)(2).

[21] IRS GCM 39,882 (May 27, 1992).

[22] Treas Reg § 1.402(c)-2 Q&A 10.

[23] Treas Reg § 1.402(a)-1(a)(2).

distribution of an annuity. The QDPA distribution is the actual in-kind distribution of the annuity itself.

Distribution of a QPDA from a plan generally will not require special language permitting the distribution of an annuity. It can generally be distributed under the normal terms of a plan document which permit lump sum distributions, as long as the lump sum distribution is not limited to a cash distribution. The QPDA can also be distributed upon the termination of the plan, if the terms of the plan so allow.[24] Just a portion of the participant's account in a defined contribution plan can be used to purchase an annuity; the entire account balance does not need to be used. This is a particularly helpful feature when designing annuity programs under DC plans, as participants can choose to make annuitization a part of an overall financial plan involving their plan balances. The insurance contract must be an annuity contract, not a life insurance contract. There does not appear to be an analogous treatment for non-annuity funding vehicles such as custodial accounts.

The distribution of a QPDA is not a rollover, and is neither reported as such nor treated for tax purposes as such. The QPDA is the payment of the balance to the credit of the employee for purposes of 402(c).[25]

<u>2.Qualified plan rules applicable to the QPDA.</u> The QPDA generally lacks a formal, governing regulatory structure, except to the extent it is also a QLAC (see below). 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.[26] As a practical matter, this has little effect. In that, a QPDA will not be accepting future contributions, this generally means that the annuity contract must maintain the rules governing the holding, transfer and distributions related to qualified plans. There are several specific rules which do apply:

- The contract must be nonforfeitable and non-transferable, and must specifically contain these terms in order to receive favorable tax treatment.[27]
- QPDAs can accept rollovers from qualified plans, IRAs and other QPDA, as well as being able to roll funds from it into these other vehicles. The terms of the QPDA contract must specifically provide for direct rollovers.[28]

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[24] Treas Reg § 1.402(c)-2 Q&A 10.

[25] Treas Reg § 1.402(a)-1(a)(2).

[26] IRC § 401(g).

[27] Treas Reg § 1.401(a)-20 and Treas Reg § 1.401-9.

[28] Treas Reg § 1.401(a)(31)-1, Q&A-17.

- As discussed above, the J&S annuity rules and the spousal beneficiary rights under 401(a)(11) and 417 which may have arisen under the distributing plan may not be eliminated by the distribution of a QPDA.
- The minimum distributions rules attributable to 401(a) plans apply to QPDA-not the IRA minimum distribution rules (which are different than the qualified plan distribution rules). One of the major differences for insurers is that the insurance company has the affirmative duty to force the minimum distribution out of the contract, unlike under an IRA.[29]
- The 20% withholding requirement applies to distributions from the QPDA in the same manner as if it were made from a qualified plan. The payor is considered the plan administrator for these purposes.
- Except if a QLAC, there is no requirement of a filing of an annual report or registration, Form 5500; nor for filing a form similar.
- One of the more quirky issues, and one which may well be addressed in further guidance, is that the prohibited transaction rules under neither IRC § 4975 nor ERISA Section 406 apply, which then means that the Code's and ERISA's investment advice restrictions do not apply. It also means that, currently, a number of financial transactions that cannot be accomplished under IRAs or qualified plans may be possible under a QPDA.

3.Application of ERISA to the QPDA. The purchase of a QPDA by a plan fiduciary for distribution to a plan participant is a discretionary act to which ERISA's fiduciary rules apply,[30] the standards which are described below. The DOL, however, has been reluctant to issue guidance as to whether, and under what conditions, an annuity contract distributed from the plan upon a distributable event remains subject to ERISA. This is an important question, as it determines whether or not the contract will be required to be reported on the distributing plans Form 5500, and whether a fiduciary has any continuing obligations related to that distributed contract.

There are compelling reasons to treat the annuity as no longer being part of the plan for ERISA purposes. The principle that a participant's benefit under a retirement plan can be distributed in the form of an annuity, thereby satisfying the plan's obligation to the participant and causing the individual to cease being a participant, dates back to the earliest days of ERISA. The statute, regulations, and DOL forms contain a number of explicit statements of and applications of this concept:

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[29] Treas Reg § 1.402(a)-1(a)(2).

[30] DOL Advisory Opinion 2002-14.

Section 29 C.F.R. § 2510.3-3(d)(2)(ii)(A), part of the ERISA regulations states:

> An individual is not a participant covered under an employee pension plan or a beneficiary receiving benefits under an employee pension plan if the entire benefit rights of the individual are fully guaranteed by an insurance company . . . licensed to do business in a State, and are legally enforceable by the sole choice of the individual against the insurance company . . . and a contract, policy or certificate describing the benefits to which the individual is entitled under the plan has been issued to the individual . . .

Thus, when a QPDA is provided to a participant or beneficiary containing all of his or her rights to benefits under the plan, the participant or beneficiary is no longer a participant in the plan.

Section 29 C.F.R. 2510.3-3(d)(2)(ii)(B) further provides an alternative to the delivery of annuity contracts for purposes of distributing a participant's or beneficiary's interest in a plan. Under this subsection, an individual is not a participant or a beneficiary under the plan if ". . . the individual has received from the plan a lump-sum distribution or a series of distributions of cash *or other property which represents the balance of his or her credit under the plan*" [emphasis added]. As noted above, a distribution of an annuity contract from the plan is specifically considered a distribution of the balance to the credit of the employee under Treas. Reg. § 1.402(c)-2 Q&A 10. Therefore, to the extent that an in-kind distribution of property (here, the annuity contract) that constitutes a beneficiary's entire benefit under the plan results in the beneficiary ceasing to be a participant under the plan.

For purposes of distributing benefits as part of the termination of a defined benefit plan, the PBGC regulations further provide that "The plan administrator must . . . distribute plan assets in satisfaction of all plan benefits by purchase of an irrevocable commitment from an insurer or in another permitted form." (ERISA regulations 29 C.F.R. § 4041.28(c)(1).) In this context, the regulations require the use of an annuity (or other permitted vehicle) to satisfy the plan's obligations.

The instructions to the Form 5500 direct that the definition of a participant for purposes of the Form 5500 does not include, ". . . any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the beneficiaries of that individual are entitled under the plan."

The QLAC rules clearly contemplate that an annuity contract is distributed from a plan, as QPDA is no longer subject to the Form 5500 rules and it establishes a completely new reporting and disclosure scheme for these contracts.

The question is further illuminated by a line of DOL Advisory Opinions ("AOs"), where the definition of what constitutes a pan asset is determined by "ordinary notions of property law." In most of these cases, the AOs are addressing situations where the sponsor of a welfare benefit plan is purchasing an insurance contract or establishing a

trust to offset the cost of the plan. The question being raised to the DOL is whether these assets are to be considered ERISA plan assets. Thus, while the facts are not directly on point, the concepts expressed by the DOL are useful in analyzing the treatment of QLACs distributed from retirement plans, and the DOL has taken the position that its welfare plan analysis is equally pertinent to retirement plans.

In AO 92-22A, the DOL observed that it has promulgated regulations identifying plan assets when a plan invests in other entities or when a participant pays or has amounts withheld by an employer for contribution to a plan. In situations not covered by the plan asset regulations, the DOL stated that, "assets of an employee benefit plan generally are to be identified on the basis of ordinary notions of property rights. In general, the assets of a welfare plan would include any property, tangible or intangible, in which the plan has a beneficial ownership interest." In the DOL's view, a plan obtains a beneficial interest in particular property if, under common law principles of ordinary notions of property rights, the property is held in trust for the benefit of the plan or its participants and beneficiaries or the plan otherwise has an interest in such property. If not, the property is not part of the plan. In AO 92-22A (and in a similar analysis in AO 92-02A), a split dollar life insurance policy was issued to the employer to fund a death benefit plan. Because the insurance policy in question was owned by the employer, not the plan, the DOL was persuaded that it was not an asset of the plan.

It seems clear under this guidance that an individual annuity contract, once distributed by the plan, is no longer subject to ERISA if it is issued to the former participant. 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 on 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 by the employer or the plan, there is a strong likelihood that the certificate would still be considered a plan asset. Should the employer or plan owning the group contract retain only nominal rights under the individual certificate, then there is a strong likelihood that the QPDA would not be considered a plan asset.

4.Security law impact of QPDA. A participant's account balance invested in variable accounts within a retirement plan which is qualified under IRC § 401 is generally considered (but for a few notable exceptions) an "exempted security," which means that the interests in the typical defined contribution plan are not required to be registered under the Securities Act of 1933 ("33 Act").[31] This is truly a limited exception, as this relief does not apply, for example, to variable interests in 403(b)

[31] SEC Release No 33-6188 (Feb 1, 1980); SEC Release No 33-6281 (Feb 3, 1981).

plans. The QPDA raises the 33 Act question, that is, at what point is the QPDA subject to registration under the Act. There are certain things which are clear:

- A fixed annuity contract, or one with only fixed investment benefits, is not required to be registered.[32] This means that issuing a QPDA with an immediate, fixed payout, or one in which there is only a guaranteed fund within the contract, can be issued without regard to registration requirements.
- A QPDA in which the interests of employees are involuntary made and non-contributory will also not be considered a security,[33] which likely means that a forced distribution of a QPDA as a terminating distribution from a profit sharing plan need not be registered.
- A QPDA issued "in connection" with a plan that meets the tax qualification requirements of 401 will be an exempted security.[34]

The question, however, is under what circumstances will a contract be considered as being issued "in connection" with the plan as opposed to being the voluntary purchase of a variable security. On one end of the spectrum is the issuance of a QPDA certificate from a non-registered group annuity contract owned by a plan, where registration requirements are unlikely. The other end of the spectrum would involve the purchase and issuance of individually owned variable QPDAs. It is likely that the SEC would resist a claim that these sorts of individual contracts need to be registered.

A financial service company will need to determine whether or not its QPDA product needs to be registered, as the requirements of registration affects the flexibility and expense underlying these products. It will also affect the manner in which these products can be distributed, and the manner in which compensation is paid. Product sponsors will have liability should they fail to properly comply with the SEC's rules. From a plan sponsor's view, familiarity with this issue will likely be a piece of their own fiduciary review.

[4] Applying the Rules: The QLAC

The IRS has issued proposed regulations establishing the Qualified Longevity Annuity Contracts.[35] One of the key features of the QLAC is that it incorporates a number of the elements of the QPDA, as well as Revenue Ruling 2012-3, in demonstrating how DC annuitization can work. In essence, the QLAC is designed to be purchased by any DC plan, regardless of whether it is otherwise funded with trust

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[32] Section 3(a)(8) of the Securities Act of 1933, 15 USC 77c-a(8).

[33] SEC Release No 33-6188 (Feb 1, 1980); SEC Release No 33-6281 (Feb 3, 1981).

[34] SEC Release No 33-6188 (Feb 1, 1980); SEC Release No 33-6281 (Feb 3, 1981).

[35] Prop Treas Reg 1.401(a)(9)-5, 77 Fed Reg 5443 (Feb 12, 2012).

held equity investments or in group annuity contracts.

The following is not intended to describe the QLAC in close detail, but to outline the manner in which it well describes DC annuitization.

1.Description of the QLAC. 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. This is important because, as noted above, the value of an investment in an annuity would otherwise need to be included in determining the required minimum distribution. This could make it difficult for a participant to comply with the minimum distribution rules.

The QLAC would have the following characteristics which are relevant to the discussion on DC lifetime income:

- Annuity. The QLAC would be required to 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 QLAC.
- Plans. The QLAC would fit within the regulatory scheme that applies to qualified plans. A purchased annuity would become an asset of the 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. The rules that apply to qualified plans with respect to annuities as investments would to 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 QLAC could be distributed as a nontaxable distribution from a qualified plan or IRA, and the contract could be rolled over between plans and IRAs in accordance with applicable rollover rules.

§ 13.03 FIDUCIARY CONSIDERATIONS RELATED TO LIFETIME INCOME

[1] Selection of an Annuity Provider

There are two major fiduciary issues related to the provision of lifetime income for DC plans. The first, and more controversial, is the apparent lack of a usable fiduciary standard upon which an employer may rely in choosing an annuity carrier. The second fiduciary concern relates to the elements of an annuity contract which must be reviewed in determining if the design of the annuity contract, itself, meets with the fiduciary standard.

There has been ongoing difficulties with the establishment of a fiduciary standard to be applied to the selection of an annuity carrier for use to fund a lifetime annuity payment under defined contribution plans. This arises by the intractable nature of the risk, that a plan's fiduciaries may be held financially responsible for financial losses to plan participants from the future insolvency of the insurer issuing the annuity.[36]

1.Background of regulatory approach. The DOL had originally issued fiduciary guidance on the purchase of annuities by a DB plan in 1995, Interpretive Bulletin IB-95-1[37] in response to losses arising to plans and participants from the purchase of annuities issued by Executive Life Insurance Company of California ("ELIC"). ELIC, an insurance company which funded its annuity obligations with high paying, high risk "junk bonds," offered annuities to retirement plans based on assumed interest that were much higher than rates in the general marketplace. These high rates lessened the cost of annuities for defined benefit plans, which meant companies using these annuities would have a greater likelihood of receiving a reversion to the company upon the termination of their pension plans. ELIC went bankrupt because their junk bonds failed, and many plans suffered losses.

The ELIC bankruptcy led the DOL to establish its "safest available annuity standard" for the purchase of annuities for terminating DB plans. In 2002, the DOL

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[36] See, for example, Meinhardt v Unisys Corp (*In re* Unisys Sav Plan Litig), 173 F3d 145 (3d Cir 1999).

[37] 29 CFR § 2509.95-1.

extended this rule to cover annuities purchased by defined contribution plans as well.[38]

In response to concerns that the "safest available annuity" standard set too high of a standard for the purchase of annuities on a regular basis from DC plans (where it seems to imply that there can only be one safest available annuity), Congress included Section 625 in the Pension Protection Act of 2006.[39] Section 625 required the DOL "issue final regulations clarifying that the selection of an annuity contract as an optional form of distribution from an individual account plan to a participant or beneficiary which (1) is not subject to the safest available annuity standard under Interpretive Bulletin 95-1 and is subject to all otherwise applicable fiduciary standards."

The DOL then issued its new guidance in accordance with this Congressional direction,[40] calling it an annuity safe harbor regulation. Fiduciaries meeting the terms of this safe harbor would be satisfying their fiduciary obligations under ERISA with regard to the selection of an annuity safe harbor.

2.The safe harbor regulation. The protection of the safe harbor regulation is available if the fiduciary:

a) Engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;

b) Appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;

c) 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;

d) "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

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

The issuance of the safe harbor was controversial in itself because it did not expressly provide for the use of insurance company ratings issued by commercial rating services.

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[38] Advisory Opinion 2002-14.

[39] The Pension Protection Act of 2006 (Pub L No 109-280), 120 Stat 780.

[40] 29 CFR § 2550.404a-4.

Instead, suggestions related to the use of ratings were discussed in the regulation's preamble,[41] along with a number of other relevant points. The preamble to these regulations states:

> An annuity provider's ratings are not part of the safe harbor, though they are encouraged to be used.

The preamble did not note, however, that ratings can be notoriously misleading for a variety of reasons. ELIC is reported[42] to have maintained an AAA rating during times it was selling its annuities to retirement plan.

> Plan sponsors are encouraged to assess the protections that may be available through state guaranty associations.

State guaranty associations provide a measure of protection to insurance policy holders where an insurance company within a state becomes insolvent, but the preamble did not discuss their limitations. These are unfunded obligations of other insurance companies within the state and are quite different from an insurance program such as the FDIC. This is an imperfect system, and insurance companies are severely restricted by law from discussing this guarantee with their policyholders. To assess the protections of this system, data needs to be accessed by the plan sponsors or their advisors.

> Experts are not necessarily required to be used in the assessment. However, given the confusing and often sophisticated knowledge required in order to understand an insurer's balance sheet, it is clear that the safe harbor could not be utilized without retaining a specialized expert.

The Fifth Circuit Court of Appeals criticized these standards as focusing on the quality of the annuity products selected instead of on the fiduciary process itself.[43]

3.Nature of the insolvency risk. The safe harbor provides little useful guidance which employers can use in the selection of an annuity provider. It actually begs the question on how does a fiduciary get comfortable with the long term insurer solvency risk.

In large part this is because it is an issue which has dogged purchasers of annuities for a very long time. The pooling of risk and the undertaking of this solvency risk have developed to become critical societal functions, as 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 this risk. It is this state regulation which should be integrated by both the DOL and courts in

[41] 73 Fed Reg 195 (Oct 7, 2008), pp 5847–5849.

[42] 73 Fed Reg 195 (Oct 7, 2008), pp 5847–5849.

[43] Bussian v RJR Nabisco, Inc, 223 F3d 286 (5th Cir 2000).

their assessment of the extent to which any individual fiduciary should be held responsible for losses related to an insurer's insolvency. The following summarizes the manner in which states generally manage this risk:

- State law requires the maintenance of adequate reserves for the risks taken on by the insurance company.
- 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 submit regular and substantial reports to their state regulators. These examinations cover not only the level of a company's reserves, but also include many aspects of the company's operation to determine if it is being run soundly.
- Insurance companies are required to participate in their state guarantee associations to protect the policyholders of all companies within the state.
- A review of marketing material of all insurance products is required, and insurance companies have the duty to supervise the activities of their agents.

The system is an imperfect one, and many states regulate insurers better than others. But the any appropriate fiduciary standard needs to take into account the broad nature of the insolvency risk, and the manner in which the states address them.

[2] Proposed Fiduciary Standards for Selecting a Fiduciary Provider

Though the annuity safe harbor itself is unlikely to provide the fiduciary relief sought by fiduciaries because of its general nature and its necessity to access and process a high degree of financially sophisticated information, it does suggest a process under which a fiduciary can comfortably follow in making a fiduciary determination.

The *Bussian*[44] opinion is instructive in the discussing the manner in which a fiduciary standard should be applied. In determining compliance with ERISA's prudent man standard, courts should objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate, and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions. ERISA's test of prudence is one of conduct, and not a test of the result of performance of the investment as is suggest by the DOL's annuity safe harbor. The focus of the inquiry is

[44] Bussian v RJR Nabisco, Inc, 223 F3d 286 (5th Cir 2000).

how the fiduciary acted in his selection of the investment (often referred to as "procedural prudence"), and not whether his investments succeeded or failed. Thus, the appropriate inquiry is whether the fiduciaries, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.

In this selection of an annuity provider, the appropriate inquiry should not include requiring the fiduciary to take on the sophisticated obligation of the state in regulating the solvency of the insurer. Instead, the inquiry should be whether the fiduciary became familiar with the decisions and recommendations of those charged with the responsibility (including state officials) of having the requisite financial sophistication necessary for such evaluations.

This approach suggest that a fiduciary (or its advisor) should make a number of inquires of its insurer as to the determinations made by others in assessing the financial well being of the insurer. This is much in the nature of the information given to financial analysts who make determinations of whether or not to invest in the publicly traded stock of an insurer. A possible list of appropriate inquires may include demands for the following explanations:

- any assessment of the insurer's financial condition that independent third parties have provided to it (such as ratings), or have been disclosed to a regulatory authority (such as the state insurance department);
- any material changes in its financial condition in the past five years, a description of the cause of those changes, and whether those changes affected the interest rate upon which annuity pricing is based;
- material outcomes of the most recent state insurance exams;
- the level of reserves, and why it was chosen; and
- the risk profile of the investment portfolio that supports the annuity contracts.

Insurers must be willing to provide a great deal more transparency about their own businesses to a fiduciary if that fiduciary is going to make a decision about who is going to provide lifetime income for its plan participants. The above sorts of information will be particularly useful, and understandable, to a fiduciary when it is presented in a competitive situation.

Prudence also suggests that fiduciaries will also need to become familiar with the plans and their participants rights under state insurance insolvency rules, should the chosen carrier become insolvent, and consider whether to commit, perhaps by way of the plan's Investment Policy Statement, to represent and assert participant claims upon insurer insolvency.

It is highly unlikely that most plan sponsor will be able to conduct a review of an annuity carrier without the assistance of a financial advisor, and thus potentially limit their own liability to their selection of an advisor rather than the selection of the carrier.[45]

[3] 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. There are a number of issues which will go into an appropriate fiduciary review of the terms of an annuity product, a review which should be documented as part of a sound fiduciary process.

1.Costs. Check for annuity purchase rates, comparing what benefit is being purchased for what price. Though "fees" are the typical focus of fiduciaries, fees should not be looked at in isolation when reviewing annuities. What should be included in the review is a determination of how much benefit can be purchased for what price, and the terms under which those prices can be changed over the course of the contract. This should also include a review of commissions which are payable under the contracts.

2.Expenses. There is tremendous variation in the fees charged under an annuity contract for the package of financial services it provides. Though they may take the form of asset charges, there may also be separate account management fee if there are investment accounts. It is important to seek an explanation of contracts' expenses.

3.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.

4. 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). Along with this, the fiduciary should review the manner in which termination rules apply to the general account investment (often referred to s the "stable value fund"). If the terms related to that general account benefit are not designed properly, it may run afoul of ERISA's prohibited transaction rules as describe by the U.S. Supreme Court in *Harris Trust*.[46]

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[45] The fiduciary must also monitor the advisor to insure that it has the expertise necessary, is not providing conflicted advice, and is properly using the advisor. *See*, for example, Gregg v Transp Workers of Am Int'l, 343 F3d 833 (6th Cir 2003).

[46] John Hancock Mut Life Ins Co v Harris Trust & Sav Bank, 510 US 86, 114 S Ct 517, 126 L Ed 2d 524 (1993).

5.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. Make sure the company has the ability to provide appropriate ERISA support for the product, including 408b(2) disclosures; the 404a-5 information; Schedule C or Schedule A information; and SSAE-16 opinions.

6.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.

7.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 alongside an annuitization guarantee.

8. Advisor rules. If allowing participants a choice of annuities; if an advisor is used; and if any of products are registered products; make sure the advisor follows FINRA's suitability rules.[47]

9.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.

Caution should be exercised when attempting to purchase an individual annuity for a plan which has not been specifically designed for that purpose. These annuities tend to be complex, expensive, and provide little ERISA compliance support.

§ 13.04 SUMMARY

The increasing reliance of regulators and the marketplace are putting on DC plans to provide retirement security is causing plans to seriously consider ways in which to provide lifetime income from these plans. Though there are steps which regulators can take in order to facilitate this change, existing law does provide opportunity for fiduciaries and plan sponsors to choose appropriate products which can provide for this type of security.

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[47] Financial Industry Regulatory Authority [FINRA] Manual rule 2111.