Treasury Department and IRS Release Initial Lifetime Income Guidance; Additional Guidance Expected Shortly

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Two years after the Internal Revenue Service (IRS) and U.S. Department of Labor (DOL) jointly issued a high-profile Request for Information regarding how defined contribution plans can better provide lifetime income, the IRS and Department of the Treasury have issued some initial guidance. DOL guidance, expected to further underscore the importance of the issue, is anticipated “in the near future.”

On February 2, 2012, the U.S. Department of the Treasury and the Internal Revenue Service (IRS) released proposed regulations and a new Revenue Ruling relating to the purchase of longevity annuities (sometimes referred to as “longevity insurance” or a “deeply deferred annuity”) inside defined contribution retirement plans and individual retirement accounts (IRAs). The new guidance is an initial package of guidance intended to remove regulatory barriers and simplify the offering of lifetime income benefits to retirees.

Introduction

The decline of traditional defined benefit pension plans and the increasing prevalence of defined contribution retirement plans (such as 401(k) plans) has created significant interest in providing lifetime income for participants in defined contribution plans, particularly after the economic downturn of 2008 decimated the account balances of many participants approaching retirement age. In February 2010, the IRS and the Department of Labor (the DOL) issued a joint Request for Information (RFI) on the use of annuities in 401(k) plans, and received nearly 800 written comments from a variety of organizations. In September 2010, the DOL and IRS held a joint hearing to receive testimony on issues such as specific participant concerns regarding the selection of a lifetime income option relative to other distribution options; the potential disclosure of 401(k) account balances as monthly income streams; and the potential fiduciary safe harbor for selection of lifetime income issuer/product.

In the intervening two years, DOL and Treasury/IRS officials have repeatedly indicated their interest in facilitating lifetime income for defined contribution plan participants, but no guidance had been issued. Several large employers have implemented or announced their intent to implement lifetime income options for participants in their defined contribution plans—notwithstanding the prior lack of DOL and IRS guidance.

In connection with issuing this new guidance, the President's Council of Economic Advisors issued a report entitled "Supporting Retirement for American Families" (Report). The Report describes a wide range of risks that can threaten a secure retirement for retirees, such as low rates of return and high administrative fees, unpredictable life events such as medical emergencies, increased life expectancies and other related factors. The Report advocates for the use of annuities to mitigate that risk by providing retirees with a guaranteed stream of income for life. In particular, the report noted that a longevity annuity contract—not a new insurance product, but simply a form of deferred annuity beginning at an advanced age (*e.g.*, 80 or 85)—can help alleviate some of those risks.

This initial round of Treasury and IRS guidance on lifetime income focuses primarily on how the minimum distribution rules, joint and survivor rules, and disclosure rules apply to longevity annuity contracts. Each of those topics is discussed in this newsletter. In addition, at the same time the IRS and Treasury issued the guidance regarding longevity annuity contracts, they also issued two additional pieces of guidance:

- A separate Revenue Ruling (Rev. Rul. 2012-4) describing how distributions from an employer's defined contribution plan may be rolled over to an employer's defined benefit plan (what the Report referred to as "self-annuitization"). It is unclear whether employers will be willing to *increase* liabilities under their defined benefit plans.
- Proposed regulations designed to encourage participants in defined benefit pension plans with a choice between lump sum and annuity benefits to choose to receive at least part of their benefit in the form of annuity (what the Report referred to as "partial annuitization"). This is designed to address a concern that many defined benefit plans have increasingly made lump sum cash payments either by adding a lump sum option to the plan's payout choices or converting the plan to a "hybrid" lump sum-oriented format, such as a cash balance plan, and that it would be desirable to offer combination options that avoid forcing participants to make an "all or nothing" choice. However, as discussed in Proposed IRS Regulations on Partial Lump Sum Pensions Require Comparison With Plans' Benefit Calculation Methods, the proposed regulations regarding partial annuitization may raise bigger questions than they solve.

How to Apply the Minimum Distribution Rules to Longevity Annuity Contracts

Relief from the required minimum distribution rules under Internal Revenue Code (Code) section 401(a)(9) is needed because the value of an annuity contract held under a defined contribution plan that has not yet been annuitized is included in determining the required minimum distributions from the participant's individual account. This could have the effect of requiring distributions from a longevity annuity to commence earlier than desired (*i.e*., at age 80 or 85).

To avoid that result, the new proposed regulations provide that the value of a deferred annuity meeting the requirements of qualifying longevity annuity contracts (QLACs) is *not* included in the account balance in determining required minimum distributions. In order to qualify as a QLAC, a number of requirements must be met. First, the amount of premiums paid for the deferred annuity under the plan may not exceed the lesser of 25 percent of the participant's account balance on the date of payment or $100,000 (reduced by the aggregate premiums paid for any other QLACs). Next, payments must commence no later than when the participant attains age 85. Further, the only benefit permitted to be paid from a QLAC after a participant's death is a life annuity, payable to a designated beneficiary, that meets certain requirements; no commutation benefit or right to receive the QLACs cash value is permitted. Variable annuities and equity-indexed contracts cannot qualify as a QLAC.

The proposed regulations apply to longevity annuity contracts purchased under tax-qualified defined contribution plans (such as Code section 401(k), 401(a) and 403(b) plans), individual retirement annuities and IRAs, and eligible governmental Code section 457 plans. The regulations do not apply to defined benefit plans or to Roth IRAs that, prior to the participant's death, are not subject to the minimum distribution requirements.

New Disclosure and Annual Reporting Requirements Applicable to Longevity Annuity Contracts

Under the proposed regulations, issuers of QLACs would be required to create a report, in plain language, describing the dollar and percentage limitations, annuity starting date and other related information, and to furnish each participant in whose name the QLAC has been purchased the information provided in the report. This statement is not required to be filed with the IRS. To comply with these reporting requirements, issuers must furnish the report beginning with the year in which premiums are first paid and ending with the earlier of the year the participant attains age 85 or dies. The forms, filing instructions and filing deadlines remain in development.

Applying Existing Survivor Annuity Rules to Longevity Annuity Contracts

Issued in tandem with the proposed regulations, new IRS Revenue Ruling 2012-3 clarifies how the qualified joint and survivor annuity (QJSA) and the qualified pre-retirement survivor annuity (QPSA) apply when a deferred annuity is purchased under a defined contribution plan. In general, the existing survivor annuity rules require that a participant who elects an annuity form of payment that does not qualify as a QJSA to obtain the written consent of the participant's spouse to that election. The IRS has acknowledged concerns as to how and when that requirement applies if a participant elects a deferred annuity. The ruling addresses three different situations, including the purchase of a deferred annuity, and explains in each case when the plan becomes subject to QJSA and QPSA rules, essentially identifying plan and annuity terms that will automatically protect spousal rights without requiring spousal consent before the annuity begins. Revenue Ruling 2012-3 also clarifies that, assuming the plan separately accounts for the deferred annuity contract, the remainder of the plan is not subject to the QJSA and QPSA requirements.

Next Steps

Comments on the proposed regulations regarding longevity annuity contracts and on the proposed regulations regarding partial annuitization are due by May 3, 2012. A public hearing on both sets of proposed regulations is scheduled for June 1, 2012.

Observations

As noted in a Treasury Department Fact Sheet, the Revenue Rulings and proposed regulations described in this newsletter are only a first step in helping address what many employers view as a critical need to help participants in their defined contribution plans ensure they have adequate retirement incomes. This initial guidance does not attempt to address all of the issues raised by public comments in response to the DOL and IRS joint RFI. Rather, the guidance was intended to address some specific impediments to the use of longevity annuities that commentators indentified in responding to RFI, and to make it easier—and perhaps more cost-effective—for participants to transfer defined contribution plan amounts into annuities that will guarantee monthly payments until the participants die.

It is unclear whether this initial Treasury and IRS guidance alone will spark interest in longevity annuities—at least inside qualified retirement plans. Longevity annuity products are not new, and although the new guidance addresses some of the potential barriers, the application of the survivor annuity rules, the disclosure obligations and the QLAC restrictions may cause some participants to consider whether it is preferable to roll over all or a portion of their account balances into a Roth IRA, and pay income tax on those distributions but avoid some of the remaining administrative hurdles.

Guidance regarding annuities that allow participants both a lifetime income guarantee *and* the ability to remain invested in the market—so called "lifetime guaranteed withdrawal benefits," or LGWB—likely will generate additional interest in lifetime income options. That guidance reportedly remains on the Treasury Department's list of future guidance.

Another anticipated piece of guidance is a new DOL requirement for plan sponsors to communicate to participants in defined contribution plans the lifetime income that may be provided by their account balance. According to February 17, 2012, comments by Phyllis C. Borzi, Assistant Secretary of Labor for the Employee Benefits Security Administration, "[in the near future,] we will see a lifetime income illustration for benefit statements. … Our goal is to raise understanding of what participants' lump-sum distribution will buy [in lifetime income options].

In short, this initial lifetime income guidance is expected to be followed by additional lifetime income guidance from both the Treasury and Labor Departments later this year. If you have questions about lifetime income options for defined contribution plans, please contact your regular McDermott Will and Emery lawyer or an author.