

New Tax Rules Seek to Help Employers Provide Retirement Plans with Lifetime Income Options

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By Joan A. Disler, Michelle Capezza, and David D. Green

Over the past several years, there has been a continuing shift away from employer-provided defined benefit pension plans toward defined contribution plans, such as 401(k) plans, that do not typically provide for payments in the form of income for life. Government agencies have been examining how this shift has imposed increased responsibility on Americans to manage their own retirement security.

The White House Council of Economic Advisers has concluded that, while lifetime income products (*i.e.*, annuities) can mitigate the risk that retirees will outlive their retirement savings, there are several regulatory barriers to offering these products. In response to this finding, on February 2, 2012, the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") issued an initial package of proposed regulations and revenue rulings intended to remove impediments to providing annuities under defined contributions plans, such as 401(k) plans.

In assessing whether to add an annuity option to their 401(k) plans, employers need to understand how the new guidance changes the landscape.

Spousal Consent for Distributions

Unlike defined benefit pension plans, 401(k) and other defined contributions plans generally are not required to provide a spousal benefit to married participants, either in the form of a qualified joint and survivor annuity ("QJSA") or prior to retirement as a qualified preretirement survivor annuity ("QPSA"). Retirement plans that are subject to the QJSA and QPSA requirements must obtain spousal consent before a participant can waive these distribution options. Under current law, adding a lifetime income option to a 401(k) plan could subject the entire plan to the spousal consent requirements, thereby adding an administrative burden to employers administering the plan.

Proposed solution. In Revenue Ruling 2012-3, the IRS clarified that, starting immediately, a 401(k) plan may offer an annuity option beginning after retirement (*i.e.*, a deferred annuity) as an investment option and, depending upon the facts, not subject the entire 401(k) account to the spousal consent (and applicable notice) rules. Also, under certain circumstances, as long as the investment in the annuity option can be changed to another investment option (and therefore become payable as a lump sum) until the date the annuity payments starts, the spousal consent requirements will not apply to a participant's account under the plan until the

annuity start date, and will apply only to the amount used to acquire the annuity. Not until such time will the spousal consent requirements be administered.

Rollovers to Defined Benefit Plans

Because lifetime income options are already provided under the employer's pension plan, it could be more cost-efficient to pay the value of the 401(k) account as an additional annuity under the pension plan, or to combine an employer's purchases of annuities for its 401(k) plan with purchases of annuities under its pension plan.

Proposed solution. If a company sponsors both a defined benefit pension plan and a defined contribution plan, such as a 401(k) plan, the new guidance makes it easier for all or part of a defined contribution balance to be rolled over to the pension plan and paid as an annuity. Under Revenue Ruling 2012-4, the amount of this rollover benefit will not be counted when determining the maximum pension benefit the plan may pay, provided IRS-prescribed interest and mortality assumptions under Section 417(e) of the Internal Revenue Code ("the Code") are used. This ruling does not apply to rollovers before January 1, 2013, but plan sponsors voluntarily can rely upon it for rollovers before that date.

All-or-Nothing Annuities

The Treasury and IRS determined that distribution options that could provide both a lump sum and a lifetime income payment would be beneficial to participants, but the agencies recognized that the valuation of such options might be too burdensome under current law.

Proposed solution. Proposed changes to Treasury regulations under Section 417(e) of the Code (REG-110980-10, 02/03/12) were issued to allow plans to offer participants the opportunity to elect optional forms of a benefit paid partly as a lump sum and partly as an annuity, without running afoul of the minimum present value requirements under Section 417(e). In other words, the participant could elect a lump sum for a percentage of the benefit, which would be calculated using minimum present value requirements, and elect an annuity for the balance of such benefit, calculated under simpler valuation factors. These proposed regulations would apply to distributions with annuity starting dates in plan years beginning after the publication of final regulations.

Forced Commencement of the Benefit at Age 70-1/2 – Deferred Annuities

Under the "minimum required distribution rules," following the later of attainment of age 70-1/2 or retirement, a participant must start to receive certain minimum distributions of his or her retirement benefit paid over the life expectancy of the participant and/or the participant's spouse. While this requirement encourages participants to use their benefit for its intended purpose, *i.e.*, retirement income, it does not provide for the possibility that the participant will survive beyond life expectancy.

Proposed solution. The proposed regulations (REG-115809-11, 02/03/12) provide amendments to the minimum required distribution rules for defined contribution plans, IRAs, and eligible 457 plans that allow plans to add a deferred annuity option. The deferred annuity option must be scheduled to commence no later than at age 85, and use only up to a 25% portion of the participant's account (to a maximum of \$100,000, adjusted for inflation). This qualifying longevity annuity contract or QLAC would be excluded from the account balance used to determine required minimum distributions.

These regulations are proposed to be effective for contracts purchased on or after the publication of final regulations and are effective for determining required minimum distributions for distribution calendar years beginning on or after January 1, 2013. Accordingly, they cannot be relied upon now.

What Employers Should Do Now

In weighing whether to offer the annuity option in 401(k) and other defined contribution plans, employers should consider the following:

- Annuity calculations can vary significantly over time as the factors used to calculate them, such as interest rates, change. Estimates provided to participants should be thoroughly reviewed and complete explanations provided. These communications should be carefully drafted.
- Employers also should exercise care when selecting the annuity provider. While a “safe harbor” provided by the IRS would be helpful, selection and monitoring of an annuity provider may not be significantly more onerous than selecting any investment provider under the plan, even though it requires a slightly different analysis.
- Questions remain as to how to handle an annuity purchase investment option if the plan fiduciaries decide it is necessary to move to a new provider platform. Employers should review if existing funds would need to be retained by the old carrier, either permanently or for some significant transition period required by the annuity contract.
- Properly drafted participant communications are important so that participants have a clear understanding of the benefits and risks of annuities.
- The longevity annuity proposal could prove very useful to an employer that wants to allow participants to better assure that they will not outlive their retirement account balances, provided that the \$100,000 and age limits are followed.

Although not all of the provisions have been finalized, employers may wish to begin exploring potential plan design changes, as well as examining the administrative, economic, and fiduciary implications of offering lifetime income distribution options, to accommodate the trend toward providing these options in defined contribution plans.

For more information about this Advisory, please contact:

Joan A. Disler
New Jersey
973-639-8298
jdisler@ebglaw.com

Michelle Capezza
New York
212-351-4774
mcapezza@ebglaw.com

David D. Green
New York
212-351-3797
dgreen@ebglaw.com

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