



For your information

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IRS Issues Proposed Regulations and New Guidance Regarding Lifetime Income Payments Under Retirement Plans

The Treasury and IRS released proposed regulations and guidance that would make it easier for plan sponsors to offer full and partial lifetime income options within defined benefit and defined contribution plans. Specifically, the proposed regulations and guidance remove some of the burdens related to offering partial annuity options under defined benefit plans and longevity annuities under defined contribution plans, clarify the spousal consent rules for deferred annuities within a defined contribution plan, and spell out how to transfer defined contribution accounts to a defined benefit plan for annuity payouts.

Background

Traditionally, retirement needs were met by defined benefit plans that provided replacement income through a stream of payments or annuity payments. However, over time, defined benefit plans have been replaced by defined contribution plans that generally are not required to offer annuities. In addition, many existing defined benefit plans are providing a lump sum option that participants often select over an annuity payment.

The Department of the Treasury (Treasury) and Department of Labor (DOL) have been exploring ways to increase annuity options within retirement and pension plans. For example, they requested information from the public regarding the desirability and availability of lifetime income alternatives in retirement plans and held a two-day public hearing on this subject.

Lifetime Income Proposed Regulations and Guidance

Recently, the Treasury and Internal Revenue Service (IRS) issued two proposed regulations and two Revenue Rulings to facilitate offering lifetime income options in various plans. The following is a discussion of the proposed regulations and the Revenue Rulings.

Longevity Annuity Contracts

One of the major concerns of retirees is that they will outlive their retirement savings. To respond to this concern, the IRS issued [proposed regulations](#) that facilitate the use of longevity annuity contracts within defined contribution plans and IRAs by modifying the Internal Revenue Code's (Code) required minimum distribution regulations.

The proposed regulations amend the required minimum distribution regulations to permit a defined contribution plan (i.e., a plan qualified under Code Section 401(a), a 403(b) arrangement, or a 457(b) governmental plan) and a traditional IRA to exclude amounts invested in qualified longevity annuity contracts (QLACs) from the calculation of the required minimum distribution. To be considered a QLAC:

- Payments under the contract must begin no later than the annuity starting date specified in the contract, but no later than the first day of the month on or after the participant reaches age 85.
- The contract cannot contain any commutation benefits, cash surrender rights, or similar features.
- The premiums paid for a longevity annuity cannot exceed the lesser of 25% of the total account balance on the date of payment or \$100,000 (adjusted for inflation in \$25,000 increments in 2014 and later years).

COMPLIANCE ALERT: In determining the maximum amount that can be applied to purchase the longevity annuity, all amounts previously applied to purchase such annuities would be counted toward the current limit. In addition, employers generally will be permitted to rely on an employee's representation regarding premiums paid under plans of other employers and IRAs (other than Roth IRAs) toward the \$100,000 cap.

- The contract must state that it is intended to be a QLAC.
- Death benefits must meet very specific requirements depending on various factors, such as whether the beneficiary is a spouse or nonspouse, when the participant dies, and whether there are multiple beneficiaries.

In addition to meeting the above requirements, the issuer of the QLAC must provide certain notices to participants regarding the benefits available under the QLAC.

If a contract does not qualify as a QLAC, the value of the contract must be counted as an additional benefit (in addition to the account balance) in determining the required minimum distribution. In addition, longevity annuities purchased under a Roth IRA will not constitute a QLAC because Roth IRAs are not subject to the required minimum distribution rules. If a QLAC is purchased under a plan or traditional IRA and it is later rolled over to a Roth IRA, the QLAC would cease to be a QLAC after the rollover and its premiums would then be disregarded in applying the dollar and percentage limitations discussed above.

These proposed regulations would apply to annuity contracts purchased on and after the final regulations are published. Comments are due by May 3, 2012. The IRS is holding a public hearing on the proposed regulations on June 1, 2012, and topic outlines for public comment are due by May 11, 2012.

Determination of the Value of Partial Annuities

Today, many plans only permit participants to elect a single payment option with respect to their entire plan benefit. Even when a plan permits a benefit to be paid as a partial lump sum and a partial annuity, current regulations require a plan to use prescribed actuarial assumptions for valuing both portions instead of simply using the plan's regular conversion factors for the partial annuity. The second set of [proposed regulations](#) that the IRS issued is intended to make it easier for plans to offer participants the option of bifurcating their plan benefit and receiving a portion as a lump sum and the remaining portion in the form of a life annuity. The proposed regulations provide that if certain conditions are met, the prescribed Code Section 417(e) assumptions would be required only to determine the lump sum, and the plan's general option factors can be used to determine the annuity portion. Under the proposed regulations, the new rules would apply to plans that offer bifurcated benefits. The regulations describe three types of bifurcated benefits:

Separately Determined Bifurcated Benefits

- The plan provides for two separate portions of the accrued benefit that are determined without regard to any election of an optional form; and
- The plan permits a participant to select different distribution options with respect to each of those portions of the accrued benefit.

Proportionate Bifurcated Benefits

- The plan allows a participant to elect one distribution option for a portion of an accrued benefit and a different distribution option for the remaining portion;
- The distribution option selected for each option is available for the entire accrued benefit; and
- The amount of each distribution is the pro rata portion of the amount of the distribution that would be determined if the distribution election had applied to the entire accrued benefit.

Specified Bifurcated Benefit

- The plan provides for a specified amount to be distributed in a single sum with the remainder distributed as a different option;
- The single sum distribution is not available for the entire accrued benefit; and
- The amount that is not the single sum distribution is not less than the amount that would be payable if:
 - A single sum election were available for the entire accrued benefit, determined as payable at normal retirement age (or actual retirement age, if later) using the applicable interest rates and mortality table;
 - The participant elected to receive the amount as a single sum; and
 - The proportionate rules (above) are applied to the portion not distributed as a single sum.

INSIGHT

The Treasury and IRS have taken a similar position to that provided under the proposed regulations with respect to the application of the Code Section 417(e) requirements to benefits payable in different forms (e.g., under the partial restriction on accelerated payments under Code Section 436 and the determination of annual benefit limits under Code Section 415).

The proposed regulations would be effective for annuity starting dates in plan years beginning on or after the date the final regulations are published. Comments are due by May 3, 2012. The IRS is holding a public hearing on the proposed regulations on June 1, 2012, and topic outlines for public comment are due by May 11, 2012.

Clarifying the QPSA and QJSA Requirements for Defined Contribution Plans with Deferred Annuity Contract Investment Options

Generally, a defined contribution plan (that is not subject to Code Section 412) does not have to meet the Code's qualified pre-retirement survivor annuity (QPSA) requirements and qualified joint and survivor annuity (QJSA) requirements if:

- The plan provides that the participant's nonforfeitable accrued benefit is payable in full on the death of the participant to the participant's surviving spouse or designated beneficiary if there is no spouse or with surviving spouse consent;
- The participant does not elect benefits in the form of a life annuity; and
- The plan is not a direct or indirect transferee of a plan that was subject to the QPSA and QJSA requirements.

In the past, it was unclear whether deferred annuity contracts offered under defined contribution plans that allowed participants to direct their investments were subject to the QPSA and QJSA rules. In [Revenue Ruling 2012-3](#), the IRS describes various plan designs that include a deferred annuity contract that is separately accounted for under the plan and discusses whether the plan design may or may not be subject to the QPSA and QJSA requirements.

For example, a deferred annuity contract is not subject to the QPSA requirements where:

- Amounts invested in a deferred annuity contract are used to purchase a contract that provides annuity payments starting at the later of the first day of the month following the participant's retirement date or age 65;
- The amount payable under the contract is fixed on the annuity starting date and depends on the amount and actuarial factors on that date;
- Amounts invested in the annuity contract may be transferred to other investments at any time before the annuity starting date;

- The form of benefit may be elected during the 180-day period before the annuity starting date, but if no benefit is elected, the default is a straight life annuity for an unmarried participant and as an actuarial equivalent 50% joint and survivor benefit for married participants; and
- If the participant dies before the annuity starting date, the participant's surviving spouse (or designated beneficiary if no spouse) will receive a death benefit as a life annuity with a value equal to the nonforfeitable accrued benefit under the contract as of the date of death. The nonforfeitable benefit is the contract's value calculated by taking into account 100% of the amounts attributable to both elective deferrals and matching contributions.

The deferred annuity contract may be subject to the QJSA requirements if the participant does not elect another form of payment under the deferred annuity contract. However, because the plan separately accounts for the deferred annuity contract, the remainder of the plan would not be subject to the QJSA requirements even if the deferred annuity contract is.

In the second example, the deferred annuity contract is the same as above, except that it provides that:

- Amounts initially contributed to the deferred annuity contract cannot later be transferred out of the contract, and these amounts cannot be taken as a lump sum payment.
- Amounts payable under the deferred annuity contract on the participant's annuity starting date are fixed on the date the investment is made.

In this example, the deferred annuity contract investment is subject to both the QJSA and QPSA provisions because at the time a participant invests in the deferred annuity contract the participant elects a life annuity.

This particular design satisfies the requirement of a QPSA because the preretirement survivor annuity is not less than 50% of the nonforfeitable account balance as of the date of the participant's death. Furthermore, the plan is not required to provide the written QPSA explanation otherwise required by Code Section 417 or to obtain spousal consent with respect to the QPSA because the plan fully subsidizes the cost of the QPSA and a participant may not waive the QPSA or select a nonspouse beneficiary. However, if the plan does not fully subsidize the QJSA, the plan must obtain notarized spousal consent to waive the QJSA and provide the written QJSA explanation before the annuity starting date.

Finally, in the last example, the IRS states that a deferred annuity contract that was the same as in the second example but allowed a participant to make an election to have no benefits payable under the contract with respect to matching contributions in the event of death before the annuity starting date (with spousal consent) is also subject to the QPSA and QJSA requirements. In addition, because the participant may waive the QPSA, the plan would be subject to the written explanation and notarized spousal consent requirements.

Clarifying Purchasing an Annuity in a Defined Benefit Plan with Defined Contribution Plan Rollovers

Some employers who offer both a defined benefit plan and a defined contribution plan permit or have considered permitting participants in both plans to rollover amounts from the defined contribution plan to the defined benefit plan and pay out these amounts as annuities. However, under current regulations there is some ambiguity regarding which rules apply to the rollover amount. Some of the uncertainties were whether the rollover amount is to be treated as a mandatory employee contribution for purposes of satisfying the Code's nonforfeiture rules and whether this amount is excludable from a participant's annual benefit for purposes of the annual benefit limits under Code Section 415(b).

In [Revenue Ruling 2012-4](#), the IRS provides a roadmap for plan sponsors who wish to amend their defined benefit plans to accept rollovers from defined contribution plans. The IRS determined that the amounts that are rolled over from the defined contribution plan to the defined benefit plan by employees or former employees are treated as mandatory contributions and the accrued benefit derived from those contributions must be nonforfeitable. The plan will satisfy the nonforfeiture rules if the benefit from the rolled-over amount is the actuarial equivalent, determined by using the applicable interest rate and mortality table under Code Section 417(e). If there is a delay (generally beyond 180 days) between the rollover and the annuity starting date, interest on the rollover contribution is paid as required by Code Section 411(c)(2)(C)(ii). Finally, because the amount from the defined contribution plan is considered a rollover, it is not included in determining the Code Section 415 annual limits.

INSIGHT

One of the open questions relating to the rollover of defined contribution plan benefits to the defined benefit plan involved the assignment of the priority category to those benefits in the event of a distress termination of the defined benefit plan. Benefits attributable to mandatory employee contributions are given a higher priority with respect to plan assets than benefits provided by employer contributions. It remains to be seen if the Pension Benefit Guaranty Corporation will clarify its rules to make the treatment of these rollover amounts consistent with the way they are treated in the Revenue Ruling.

In Revenue Ruling 2012-4, the IRS stated that if the plan were to use a less favorable actuarial basis that results in a smaller annuity, such as an interest rate lower than the applicable interest rate, the plan would not satisfy the nonforfeiture rules. On the other hand, if the plan were to use a more favorable actuarial basis than required under Code Section 417(e) resulting in a larger annuity than required by law, then the portion of the benefit attributable to the amount of the rollover in excess of the minimum legally required amount will be treated as having been funded by employer contributions. That portion of the benefit will be included along with the plan's other annual pension amounts in applying the annual benefit limits under Code Section 415.

Finally, in Revenue Ruling 2012-4, the IRS states that if the defined benefit plan is certified or if presumed AFTAP were to drop below 60%, the defined benefit plan would not be permitted to receive the direct rollover contributions because they would give rise to additional benefit accruals.

INSIGHT

Revenue Ruling 2012-4 does not apply to rollovers made before January 1, 2013. However, plan sponsors may rely on it in regard to rollovers made before that date.

Conclusion

The proposed regulations are aimed at making it easier to offer lifetime income and other annuity options through annuity contracts in defined contribution plans and rollovers from defined contribution plans to defined benefit plans. Plan sponsors should review the proposed regulations and provide comments to the Treasury to ensure that all issues are addressed in any final regulations.

The Revenue Rulings will immediately make it easier for plan sponsors to provide lifetime income and other annuity options. However, plan sponsors need to make sure that any plans that offer any of these options strictly comply with the Revenue Rulings. As stated above, this is just the first step in easing the way for defined contribution plans to offer lifetime income options. The Treasury and the DOL both indicated that they expect to issue further guidance in this area later this year.

Buck Can Help

- Review and comment on the proposed regulations
- Provide information about the availability, pricing, and provisions of longevity annuities that are currently available
- Analyze the pros and cons of providing rollovers from a defined contribution plan to a defined benefit plan to provide additional annuity payments from the defined benefit plan
- When the proposed regulations are final, amend plans to provide for longevity annuities and/or bifurcated benefits for plan sponsors who decide to offer such benefits and ensure that selected annuity providers are both competitive and meet DOL requirements for financial security

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.
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