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IRS and DOL Encourage Annuities in Target Date Funds

The IRS issued guidance providing a special rule that allows qualified defined contribution plans to offer annuity products within a series of target date funds (TDFs) without running afoul of certain nondiscrimination requirements. In addition, the DOL issued an information letter confirming that the inclusion of deferred annuities would not prevent a TDF from qualifying as a qualified default investment alternative.

Background

In response to concerns that participants may not have sufficient funds to last through retirement, the DOL and IRS have initiated efforts to encourage plan sponsors to include annuities in retirement plans. Earlier this year, the IRS issued final regulations on qualifying longevity annuity contracts (QLACs). QLACs, if properly structured, enable a participant to start payments at an advanced age — as late as 85 — and exclude the value of the annuity from required minimum distribution calculations. (See our July 10, 2014 *For Your Information*.) QLACs had been proposed in 2012 along with a flurry of other IRS guidance aimed at encouraging lifetime distributions and avoiding leakage as described in our February 27, 2012 *For Your Information*. These included:

- Proposed regulations allowing defined benefit plans to bifurcate benefits
- A revenue ruling about rolling over defined contribution assets to defined benefit plans
- A revenue ruling clarifying qualified preretirement survivor annuity and qualified joint and survivor annuity requirements when annuities are purchased with defined contribution plans assets

In 2013, the DOL issued an *Advance Notice of Proposed Rulemaking* that would require the disclosure on participant statements of a projected account balance at normal retirement age and an estimate of the lifetime monthly annuity that the participant could buy using current and projected balances. (See our May 10, 2013 *For Your Information*.)

Against this backdrop, proponents of certain TDF arrangements that would encourage annuity purchases asked for guidance on nondiscrimination concerns that were presented by the structure of the arrangements. These TDFs are structured with a fixed income portion that includes an increasing amount of deferred annuities as the average age of the participants investing in the fund increases. Proponents of this arrangement point out that because annuity prices vary based on the age of the investor, it would not be reasonable to permit participants that are not within the fund age group to invest in the fund. If the TDFs with the deferred annuities are only offered to older participants, the benefit may disproportionately favor highly compensated employees — as older employees are likely to be higher paid than younger ones. Given this makeup, age-restricted TDFs could violate the nondiscrimination testing requirements for benefits, rights, and features of a qualified plan if each TDF is viewed as a separate feature.

> **Comment.** Many plans include a series of TDFs targeted to mature at specified retirement dates. Unlike the annuitized funds, these TDFs do not impose any age restrictions on an individual participant's ability to invest in the fund. Thus the nondiscrimination concern is not present.

IRS Requirements for Testing Relief

In Notice 2014-66, IRS provides that a TDF series of funds will be tested as a single right or feature available to all participants eligible to invest in any of the funds if certain criteria are met. This would eliminate any concerns that the feature would not satisfy nondiscrimination testing because of the inclusion of age-restricted bands in the TDF. The TDF must satisfy the following criteria:

- The group of TDFs is designed to serve as a single integrated investment program with the same investment manager for all TDFs in the series. The only permissible differences in the funds must be based on the creation of a portfolio appropriate for investors in the age band. The investment mix available to older participants must be available to younger participants as their portfolios change to reflect increasing ages.
- None of the deferred annuities in the TDF may provide a guaranteed lifetime withdrawal benefit (GLWB) or a guaranteed minimum withdrawal benefit (GMWB).
- If the TDF holds employer securities, it must be readily tradable on an established securities market.
- Only the portion of the TDF that relates to the mix of assets is exempt from the nondiscrimination requirements. All other features, namely the treatment of fees and expenses, must be consistent with other TDFs in the series.

DOL Comment Letter Addresses QDIA Status

In response to a request for comments, on October 23, Assistant Secretary of Labor Phyllis C. Borzi issued an information letter discussing the DOL's position on whether or not a TDF could serve as a qualified default investment alternative (QDIA) if the TDF invested in unallocated deferred annuity contracts.

May Qualify as a QDIA

To qualify as a QDIA, DOL requires a TDF to be designed to produce varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age or target retirement date. The DOL concludes that an investment product will not fail to qualify as a QDIA solely because the TDF includes unallocated deferred annuity contracts for the fixed income component.

At its target date, the TDF is dissolved and participants with an interest in the fund receive an annuity certificate providing for immediate or deferred commencement of annuity payments. The certificate represents the participant's interest in the unallocated deferred annuity contracts held by the fund. DOL found this to be consistent with their regulatory view that QDIAs can be offered through variable annuity or similar contracts.

Fiduciary Responsibility and the Annuity Selection Safe Harbor

Ordinarily, under the DOL's annuity selection safe harbor, the plan fiduciary is responsible for selecting an annuity provider. The fiduciary is required to:

- Engage in an objective, thorough and analytical search
- Consider information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract
- Consider the contract's cost (including fees and commissions) in relation to the benefits and services provided
- Conclude that, at the time of the selection, the insurer is financially able to make all future payments under the contract and the cost of the contract is reasonable in relation to the benefits and services provided
- If necessary, consult with an appropriate expert or experts for purposes of meeting these conditions

In the TDF arrangement, rather than having responsibility for selecting the annuity provider, the plan fiduciary is responsible to select the investment manager prudently and monitor that person at reasonable intervals to ensure that he or she is performing in accordance with the terms of the plan and satisfies the standards under ERISA. In turn, the investment manager is responsible for the selection process for the underlying investments in the fund, including the selection of deferred annuity products included in TDFs, thereby addressing the plan fiduciary's concerns over the annuity selection process.

Unallocated Deferred Annuity Contract

DOL defines an "unallocated deferred annuity contract" as an insurance contract that promises to pay income to covered plan participants at some future date on a regular basis for a period of time or for life. An unallocated annuity contract is written on behalf of the group rather than a specific individual. Insurance companies are generally not required to maintain specific information on individuals in the group because the deferred annuities are unallocated. This facilitates transferability and allocation within the group because the unallocated annuities are generally interchangeable among participants in the fund.

In Closing

This guidance is a continuation of the steps the IRS and DOL are taking to encourage participants' retirement readiness and to offer options to help enable them to develop portfolios to reduce the risk of outliving savings. It is unclear how popular the TDF with annuity products will become. The majority of 401(k) plans do not include annuities based on a lack of participant demand, administrative issues and concerns over the selection of providers. However, the guidance demonstrates the recognition that participants need tools to ensure they have sufficient assets in retirement.

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