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LEGAL ALERT

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New Tax Guidance on Use of Annuities in Retirement Plans

On February 2, 2012, the Internal Revenue Service (IRS) and Department of Treasury, together with the White House, released four pieces of guidance with the stated purpose of easing certain burdens on providing annuity distribution options under qualified plans, individual retirement accounts (IRAs) and other retirement arrangements and otherwise encouraging the use of annuity distribution options. The guidance includes:

- Proposed regulations providing exceptions to certain required minimum distribution (RMD) rules under Internal Revenue Code (Code) section 401(a)(9) for qualified longevity annuity contracts under qualified defined contribution plans, IRAs and 403(b) and 457(b) plans.
- A revenue ruling that addresses how to apply the qualified joint and survivor annuity and qualified pre-retirement survivor annuity rules to a profit sharing plan that offers deferred annuities.
- A revenue ruling providing rules for rollovers from a 401(k) or other profit sharing plan to an employer's defined benefit pension plan to obtain an annuity distribution for all or a portion of the profit sharing account balance.
- Proposed regulations that would permit defined benefit plans to provide a lump sum for a portion of the benefit and an annuity for the remainder of the benefit on more favorable terms than is permissible under current laws.

The Obama Administration has in a number of ways previously evinced its intent to facilitate lifetime income solutions in defined contribution plans. This guidance package, which Treasury announced in a press release and which was accompanied by a White House statement, a fact sheet and a report, constitutes a meaningful contribution to that effort. The fact sheet notes that Treasury and the Department of Labor expect to issue further retirement income guidance later this year.

Longevity Annuities

Longevity annuities are contracts that provide life annuity payments typically commencing at age 80 or 85; in many (but not all) cases, that is the only benefit the contract provides. As such, these contracts may offer cost-effective "tail risk" protection for a retirement plan participant's decumulation strategy. However, that contract design – in particular, the economic value of the future annuity payments that are not available for distribution prior to the specified age, and the possibility of a "doughnut hole" in distributions if a plan participant's other plan balances are exhausted prior to that age – raises questions under the RMD rules for account balance plans, which mandate that the RMD be based on the entire account balance.

The proposed regulations would provide relief from the minimum distribution requirements applicable to qualified defined contribution plans, IRAs, and 403(b) and 457(b) arrangements for "qualifying longevity annuity contracts" (QLACs). Under the proposed regulations, the value of the QLACs would be excluded from the account balances used to determine RMDs, and QLAC distributions would be treated as meeting the RMD requirements.

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Generally to constitute a QLAC:

- The amount of premiums paid for the contract may not exceed the lesser of $100,000 or 25% of the employee's account balance on the date of payment.
- The specified annuity starting date (ASD) must be no later than the first day of the month coincident with or next following the employee's attainment of age 85. After the ASD, the contract distributions must satisfy the RMD rules.
- The death benefit must be a life annuity.
- The QLAC may not be a variable contract, equity-indexed contract or similar contract, and may not provide a commutation benefit, cash surrender value or similar right.
- The QLAC must state, when issued, that it is intended to be a QLAC.
- The issuer of the QLAC must satisfy certain disclosure and annual reporting requirements.

The regulations are proposed to be effective after they become final and may not be relied upon in the interim. Comments on the rules are due May 3, 2012.

Limitation on premiums. The 25% limit applies separately to each plan. The $100,000 limit applies to all plans and is reduced by any premium payments an employee has previously made for the same contract or for any other contract under any other plan that is intended to be a QLAC. For purposes of determining whether premiums exceed the dollar or percentage limitation, a plan administrator may generally rely on an employee's representation, unless the plan administrator has actual knowledge to the contrary. However, this reliance is not available with respect to a plan, annuity or account that is maintained by an employer for an employee under any other plan, annuity or account maintained by that employer. If a premium causes the total premiums to exceed the limitation, the contract would fail to be a QLAC as of the date on which the excess premiums were paid and, as a result, the value of the contract would be included in determining the required minimum distribution amount.

Maximum age at commencement. The proposed regulations allow a participant to elect an earlier ASD than age 85 if the QLAC provides such an option. However, QLACs are not required to permit commencement prior to age 85.

Death benefits. The proposed regulations provide that the only benefit permitted after the employee's death is a life annuity. Thus, a contract that permits payment in the form of a life annuity with a period certain or provides for a refund of premiums upon death would not be a QLAC. If the sole beneficiary under the QLAC is the employee's surviving spouse, the only benefit permitted to be paid after death is a life annuity payable to the surviving spouse that does not exceed 100% of the annuity payment payable to the employee. In order to comply with the qualified preretirement survivor annuity rules, however, the proposed regulations provide an exception that will apply if the employee has a substantially older spouse.

In the case of a non-spouse beneficiary, to satisfy the minimum distribution incidental benefit requirements under Code section 401(a)(9)(G), the proposed regulations provide that the life annuity upon death is not permitted to exceed an applicable percentage of the annuity payment payable to the employee. The applicable percentage is determined under one of two tables – the percentage described in the existing table in Treas. Reg. § 1.401(a)(9)-6, A-2(c) or a new table set forth in the proposed regulations. The first table is only available if no death benefits are payable to a non-spouse beneficiary if the employee dies before the specified ASD. The new table under the proposed regulations is available when the contract provides a pre-annuity-starting-date death benefit.

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Disclosure and annual reporting requirements. The proposed regulations require the issuer of a QLAC to furnish a report to the individual in whose name the contract has been purchased prior to or at the time the employee purchases the QLAC. The report should include the following information:

- A plain-language description of the dollar and percentage limitations on premiums;
- The ASD, and if applicable, a description of the employee's ability to elect to commence payments before the ASD;
- The amount (or estimated amount) of the periodic annuity payment that is payable as a single life annuity (including, if an estimated amount, the assumed interest rate used), and a statement that there is no commutation benefit or right to surrender the contract in order to receive its cash value;
- A statement of any death benefit, including any differences between benefits payable if the employee dies before the ASD as compared to on or after the ASD;
- A description of the administrative procedures associated with an employee's elections under the contract, including deadlines, how to obtain forms and where to file forms, and the identity and contact information of a person from whom the employee may obtain additional information about the contract; and
- Other information that the IRS may require.

Information is not required to be reported to the extent the information has already been provided to the employee to satisfy applicable state law.

The proposed regulations also prescribe annual reporting requirements under Code section 6047(d), which would require the issuer of a QLAC to file annual calendar-year reports and provide a statement to the contract holders regarding the status of the contract.

Applicability to IRAs and 403(b) or 457(b) plans. Under the proposed regulations, QLACs may be purchased under traditional IRAs and 403(b) or 457(b) plans. Rules similar to the rules described above for qualified plans apply to these arrangements, except that the 25% limit applies to all IRAs in the aggregate. Annuities purchased under a Roth IRA will not constitute a QLAC because Roth IRAs are not subject to the RMD requirements.

Deferred Annuities and the QJSA/QPSA Rules

Rev. Rul. 2012-3 addresses how the qualified joint and survivor annuity (QJSA) and the qualified preretirement survivor annuity (QPSA) rules (set forth in Code sections 401(a)(11) and 417) apply to three situations in which a 401(k) plan offers deferred annuities.

In general, a 401(k) or other profit sharing plan must satisfy three conditions for the QJSA and QPSA rules not to apply to a participant under Code section 401(a)(11)(B)(iii):

- On the death of a participant, the vested account balance is payable in full to the surviving spouse (or, if there is no surviving spouse or the surviving spouse consents, to a designated beneficiary);
- The participant does not elect a life annuity; and
- The plan has not received a direct or indirect transfer of assets, on behalf of the participant, from a plan that was subject to the QJSA and QPSA requirements with respect to that participant.

The three situations addressed in the ruling make it clear that the second condition (the participant does not elect a life annuity) is not violated merely because a participant elects to invest in a deferred annuity

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contract, even if the default payment under the deferred annuity contract is a life annuity, as long as the plan permits the participant to elect a different form of payment prior to the ASD. Specifically, the plan can permit the participant to transfer amounts invested in the contract to a different investment or to elect a single-sum payment (or, presumably, installments over a fixed period) under the contract. However, at the ASD, if the participant has not previously elected to receive another form of payment, the plan becomes subject to the QJSA requirements with respect to amounts that remain invested in the deferred annuity. The remainder of the participant's account balance and the plan are not subject to the QJSA and QPSA requirements if the plan separately accounts for the deferred annuity contract.

In contrast, if a participant who invests amounts in a fixed deferred annuity contract is not later permitted to transfer those amounts out of the contract or to elect to take those amounts in the form of a single sum payment, the plan is generally subject to the QJSA and QPSA requirements for all participants who have invested in deferred annuity contracts. In that situation, if the death benefit is based on 100% of the amounts in the contract attributable to both elective deferrals and matching contributions, the QPSA requirements under Treas. Reg. § 1.401(a)-20, Q&A-20 are satisfied. In addition, the written QPSA explanation required by Code section 417(a)(3) and spousal consent with respect to the QPSA are not required if the plan does not impose a charge for the death benefit, and the participant may not waive the QPSA or select a non-spouse beneficiary. However, the QJSA rules are applicable, with the result that a married participant cannot elect a single life annuity or other optional form without his or her spouse's consent.

Finally, if a participant who invests amounts in a fixed deferred annuity contract is permitted to make an election to have no preretirement death benefit payable under the contract with respect to amounts attributable to matching contributions, that is considered a waiver of the QPSA, and the plan is required to comply with the Code section 417(a) rules with respect to the participant's waiver of the QPSA. Presumably, this rule applies to any portion of the benefit for which the QPSA can be waived.

Rollovers From a 401(k) Plan to a Pension Plan

Rev. Rul. 2012-4 provides guidance on how participants in a 401(k) plan (or other defined contribution plan) can roll over their accounts to their employer's defined benefit pension plan in order to receive a lifetime annuity. Among other things, the ruling addresses the applicability of the vesting rules of Code section 411(c) and benefit limitations under Code section 415(b).

Under the ruling, a direct rollover from a defined contribution plan to the employer's defined benefit pension plan is treated as a mandatory employee contribution to the pension plan under Code section 411(c), and the accrued benefit derived from the contribution must be nonforfeitable. Thus, if the rollover is to be converted to an immediate annuity, the amount of the immediate annuity is determined as the actuarial equivalent of the amount rolled over from the 401(k) plan, determining actuarial equivalence using the applicable interest rate and mortality table under Code section 417(e). If there will be a delay (of no more than 180 days) before the annuity attributable to the rollover begins, the conversion must be made on the same basis and interest must be credited on the amount between the date of the rollover and the ASD. The rollover, however, will not affect the pension plan's compliance with the Code section 415 limits. The benefit resulting from the rollover is excluded from the participant's annual benefit for purposes of the limits under Code section 415(b).

The ruling also specifies that if the pension plan uses a less favorable actuarial basis than required under Code section 417(e) (resulting in a smaller annuity than required under Code section 411(c)), the plan would not satisfy the requirements under Code section 411(a)(1) because a portion of the rollover would

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be considered to have been forfeited. On the other hand, if the pension plan were to use a more favorable actuarial basis than required under Code section 417(e), the excess portion of the benefit would be treated as having been funded by employer contributions and would be included in the annual pension benefit for purposes of determining whether the pension plan satisfied the limits under Code section 415(b).

Partial Annuity Distributions Under Defined Benefit Pension Plans

Finally, proposed regulations address the actuarial assumptions that must be used under a defined benefit pension plan if a portion of the benefit is paid in the form of a lump sum (or certain other optional forms) and the remainder is paid in the form of a traditional annuity. Under current rules, if any portion of the accrued benefit under a defined benefit plan is paid in the form of a lump sum, the applicable interest rate and mortality table prescribed under Code section 417(e)(3) must be used to determine actuarial equivalence for the entire accrued benefit, even the portion that is not paid as a lump sum. The proposed regulations would provide that, if certain conditions are met, the Code section 417(e)(3) assumptions would be required to be used only to calculate the lump sum, and the plan's general actuarial assumptions could be used to calculate the actuarial equivalents for the portion of the benefit payable as an annuity. Thus, the regulations are designed to encourage employers to allow participants to take a partial lump sum and a partial annuity.

The rules would apply to plans that meet one of three alternative conditions:

- A + B. Benefits under the plan are based on two or more separate formulas – *i.e.*, the total benefit is A + B, not the greater of A or B – and the participant can elect a different distribution option for the benefit under each formula. This design is common if two or more plans have been merged and for plans that have been amended to adopt a new cash balance or other type of formula for future years. The rule in the proposed regulations could also apply if the same factors are applied separately to years before and after a specified date (*e.g.*, 1 % of pay for each year up to 2005, plus 1% of pay for each year thereafter) if participants are permitted to make separate distribution elections for each portion of the accrued benefit.
- Pro-rata. The plan permits participants to elect one distribution option for one portion of the benefit and an alternative distribution option for the remainder of the accrued benefit (*e.g.*, 25% is paid as a lump sum and 75% is paid as a QJSA), each distribution option could be elected for the entire benefit, and the amount payable under each distribution option is the pro-rata portion calculated as if that option had been applied to the entire accrued benefit.
- Specified Portion. The plan provides that a specified portion of the benefit can be paid in a lump sum (*e.g.*, the portion attributable to mandatory employee contributions) with the remainder paid under another distribution option, but does not allow a participant to elect a lump sum for the entire benefit, and the amount of the annuity is not less than the annuity that would be payable under the pro-rata rule above.

The proposed regulations provide that these three alternative rules can be applied multiple times and can be combined. For example, a plan that requires mandatory employee contributions or that had required them in the past and into which other plans had been merged might apply the specified portion rule to allow a lump sum of the benefit attributable to mandatory employee contributions under the basic plan and might also apply the A + B rule for one or more of the benefits attributable to the merged plans.

The regulations are proposed to be effective only after they become final, and employers may not currently rely upon them. Comments on the proposed regulations are due May 3, 2012. In the preamble,

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the IRS and Treasury specifically note that any plan that provides for a partial lump sum and a partial annuity under the current regulations that is amended to adopt the new rules (assuming the regulations become final) will need to protect the benefits that accrued prior to the date of the amendment and the method for calculating the distribution of that portion of the accrued benefit to satisfy Code section 411(d)(6) through wear away or otherwise.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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