SUTHERLAND

LEGAL ALERT

January 4, 2011

IRS Rules Again on Annuity Issues in Defined Contribution Plans

In PLR 201048044 (September 9, 2010), the Internal Revenue Service again addressed the application of certain tax rules relating to distributions from defined contribution retirement plans in the form of an annuity.

Facts

The ruling considered a proposed target date fund with a guaranteed lifetime withdrawal benefit (GLWB) to be offered as a §401(k) investment option. As described in the ruling, the proposed fund offers the following features:

- As a participant approaches retirement age, his or her investments in the fund are automatically transitioned into group flexible premium variable deferred annuity contracts with a GLWB feature provided by multiple insurance companies. A GLWB generally provides a participant with a minimum guaranteed annual payment stream for life, regardless of his or her account balance.
- The annuity contract value continues to be invested in a target date strategy. Because of the GLWB feature, the participant's mix of equity-to-fixed-income instruments does not decrease as the participant reaches retirement. Instead, the participant's investment under the target date strategy retains significant exposure to equity.
- Beginning at age 62 and after the participant terminates employment, the participant may elect to receive the GLWB.
  - If the participant takes no other action after electing to receive the GLWB, the participant will continue to receive payments for the remainder of his or her life in an amount equal to or exceeding his or her initial guaranteed withdrawal amount, regardless of whether he or she has any remaining contract value.
  - A participant may alternatively choose to withdraw all or part of the remaining funds in his or her contract. If a participant chooses this option, his or her future GLWB payments are decreased, and discontinued entirely if the participant withdraws the entire contract value.
  - A participant may also choose to skip a guaranteed withdrawal or withdraw less than the guaranteed amount or add funds to the contract value. This will generally increase the participant's future GLWB payments.
  - GLWB payments, to the extent due and owing, are withdrawn from the contract value until that value is exhausted, and then are paid by the insurance companies from their reserves.
- A participant who never elects to receive a GLWB may withdraw funds from his or her contract value at any time on an ad hoc basis, in which case the participant is entitled to no further benefits once all amounts are withdrawn from the fund.
- The remainder of the contract value, if any, will be paid to the participant's spouse upon the participant's death.

Rulings

Based on these facts, the IRS ruled as follows:

- The GLWB under the target date fund constitutes "payment in the form of a life annuity," and therefore any participant election to receive a GLWB will subject that participant's benefits to the qualified joint and survivor annuity (QJSA) rules. This would include guaranteed withdrawal payments made under the GLWB while the participant still has an account balance and therefore is still able to control the timing and amount of payments and is still permitted to make additional contributions to his or her account. The IRS looked to the definition of "life annuity" under the QJSA rules and reasoned that the GLWB provides retirement payments and requires the survival of the participant as one of the conditions for possible payment. The IRS clarified that a mere election to invest in a target date or other fund with a GLWB feature would not subject a participant's benefits under the plan to the QJSA rules (assuming the plan is otherwise exempt from those rules). Rather, only the election to receive the guaranteed lifetime withdrawals triggers the QJSA rules.

- The applicable annuity starting date for QJSA purposes is the date that the participant elects to receive the GLWB and the dates, if any, of an increase in the guaranteed withdrawal amount due to the participant's transfer or rollover of funds into the target date fund. Thus, any participant QJSA waiver and corresponding spousal consent would need to be received within 180 days before the participant elects to receive the GLWB (or any date of increase in the guaranteed amount, if applicable); otherwise, the GLWB would need to be paid as a QJSA.

Comments

- PLR 201048044 seems conceptually inconsistent with PLR 200951039, issued 12 months earlier by a different IRS ruling group. The IRS looked to different sources of law and reasoned differently in the two rulings. The logic of PLR 200951039 suggests the QJSA annuity starting date in PLR 201048044 should be the date the annuity contract value is exhausted and the insurance companies commence GLWB payments from their reserves.

- Neither of the products considered in the rulings is the most typical product in the marketplace. Because the GLWB in PLR 201048044 was to be provided by multiple carriers under different contracts, for example, the Service's conclusion as to the QJSA annuity starting date may be the most practical conclusion on those facts. It is possible that other product designs might be analyzed differently.

- More generally, these rulings illustrate the inherent limitations of addressing issues of this character through the private letter ruling process. There is an important policy question whether guaranteed lifetime income structures like GLWBs should be treated as "payments in the form of a life annuity" for QJSA purposes and, if so, how the mechanics of the QJSA rules should be applied to them. The Treasury's ongoing lifetime retirement income project, which is not limited to the facts of one particular situation and the rulings requested by any particular taxpayer, may provide a better venue for considering those policy issues.

■ ■ ■

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.

Daniel M. Buchner	202.383.0869	daniel.buchner@sutherland.com
Adam B. Cohen	202.383.0167	adam.cohen@sutherland.com
Jamey A. Medlin	404.853.8198	jamey.medlin@sutherland.com
Alice Murtos	404.853.8410	alice.murtos@sutherland.com
Joanna G. Myers	202.383.0237	joanna.myers@sutherland.com
Robert J. Neis	404.853.8270	robert.neis@sutherland.com
Vanessa A. Scott	202.383.0215	vanessa.scott@sutherland.com
W. Mark Smith	202.383.0221	mark.smith@sutherland.com
William J. Walderman	202.383.0243	william.walderman@sutherland.com
Carol A. Weiser	202.383.0728	carol.weiser@sutherland.com