The Effect of The Lincoln National Life Insurance Company Private Letter Ruling on the Retirement Income Debate

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Ruling request

With the advent of fewer defined benefit plans, uncertainty surrounding the solvency of Social Security, the historically low personal saving rates in the United States, and the proliferation and popularity of defined contribution plans, insurance companies have devoted considerable energy and effort to enable plan sponsors and plan participants to use their defined contribution balance to provide personal retirement security—including income for the rest of the participant's life. As many insurance companies began to develop guarantees inside defined contribution (DC) plans, such as guaranteed minimum withdrawal benefits, imbedded annuities in a plan investment, and other types of annuities with their DC offering, The Lincoln National Life Insurance Company sought to gain an understanding of the application of tax planning rules for these products through a private letter ruling from the Internal Revenue Service. In August of 2005, prior to the introduction of most guaranteed products in the DC market, Lincoln asked the IRS to rule on its *i4LIFE*® Advantage and the integration of *i4LIFE* into its DC product offering.

i4LIFE

i4LIFE® Advantage, an *Income4Life*® innovation, is an annuity distribution option available within individual retirement annuities and defined contribution plans offered by Lincoln. *i4LIFE*, a patented distribution method available on variable annuity products, offers lifetime income with access to the account value. The lifetime income is a variable annuity payment with the potential to grow with the investment; however, in our defined contribution products, the income payment is protected by a guaranteed minimum payment of 75% of the initial payment. The guaranteed minimum payment may also grow with a rise in subsequent income payments. However, if a market downturn results in a payment that would be less than the guaranteed income level, the difference is drawn from the account value. If an extended downturn exhausts the account value, access to assets and the death benefit end, but GIB payments will continue for life.

A unique feature of *i4LIFE* is the *access period*. During the access period, a participant or annuitant has access to their account balance as well as many other rights not normally associated with an annuity. A participant can stop the payments and surrender his or her account value in a lump sum, stop the income payments and return the account value to the accumulation phase with the ability to reelect *i4LIFE* again at a future date, or lengthen the access period to decrease the level of income payments and extend the ability to access the account value. However, if you take additional withdrawals, the values will be reduced by more or less than the amount withdrawn. If all assets are withdrawn, payments will stop and the contract will end. The maximum length of time you can have access to your assets and a death benefit is to age 100 (single) or age 95 (joint).

The IRS ruling on the access period and the transition from the access period to the annuity phase of the product will influence product design by Lincoln Life and other insurance companies in the coming months and years.

The IRS ruling

Late in 2009, the Internal Revenue Service released PLR 200951039 to The Lincoln National Life Insurance Company, which addresses the application of plan distribution rules to Lincoln variable annuity contracts with the *i4LIFE*® Advantage rider. Specifically, The Lincoln National Life Insurance Company asked the IRS if the election of *i4LIFE* would require the application of Qualified Joint and Survivor Annuity (QJSA) rules upon the initial election of *i4LIFE* at the start of the access period *or* if the QJSA rules would not apply until the access period is over and the balance is converted to a traditional life annuity. As a point of reference, §417(a) generally provides that a plan that is subject to §401(a)(11) must permit a participant to waive the QJSA, with notarized spousal consent, during an election period and must provide a written explanation to the participant of the terms and conditions of the various annuities offered within the plan. With respect to profit-sharing plans, including 401(k) plans, the requirements of §401(a)(11) generally do not apply unless the participant elects to receive his or her distributed benefit in the form of a life annuity. The IRS noted that the participant generally only makes one election when he or she elects *i4LIFE* and that a life annuity will automatically follow the access period. Without a second election, the IRS determined that the initial election of *i4LIFE* was the election of a life annuity and the requirements of §401(a)(11) and §417(a) should be instituted at the time of the election. Thus, the notice requirements, notarized spousal consent procedures, and other QJSA requirements would need to be implemented when the *i4LIFE*® Advantage election was made, and it could not be delayed until the end of the access period when the traditional life annuity payments begin.

Implications

The private letter ruling only applies to Lincoln Financial Group and only with respect to the facts in the private letter ruling. It does, however, give insight into the IRS's thinking, and how they would interpret regulations and rules in similar situations and for similar products. As such, service providers often extrapolate IRS rulings to determine how they might apply to their own product lines and administrative practices. In so doing, other service providers might conclude that their own imbedded annuities and product offerings may have to institute the QJSA administrative procedures and implement those same procedures much earlier than anticipated. In question are designs that utilize the guaranteed minimum withdrawal benefit or a systematic purchase of a deferred life annuity during the accumulation stage, both of which have participants making an election and beginning payment for the benefit early in the contractowners' working careers. The guaranteed products generally have two components: (1) an accumulation component or guarantee during their savings or accumulation years, and (2) a lifetime income component upon their retirement. Insurance companies designing such benefits for DC plans will need to make two determinations: (1) does the request to commence the withdrawals or income payments constitute a "second election"? and (2) does the withdrawal or income phase constitute a life annuity? If the withdrawal or income phase is a life annuity that is the automatic result of the initial election of the benefit by the participant, then the plan sponsor and the insurance company should institute the §401(a)(11) requirements coincident with the initial election of the benefit. This determination of a "second election" is complicated by a design that offers a single life benefit, which must be selected at the beginning of the program rather than at the time withdrawals or income commence. In other words, the QJSA notice and spousal consent requirements may need to be addressed prior to contributions being made by the electing plan participant.

i4LIFE® **Advantage elections**

Since the election of *i4LIFE* currently occurs at the point of distribution, the implementation of the QJSA administrative procedures seem reasonable and intuitive at this time. The distribution election is generally where the QJSA notices and waivers occur. However, for other types of recent guarantees and in plan benefits such as the election of a GMWB or other imbedded annuity, the QJSA administrative requirements seemingly may need to be made when the participant first elects the savings vehicle/guarantee. If so, this would need to be administered for all plan participants—even married participants in their 20s when retirement and distributions are 40+ years away.

The implication of the QJSA administrative procedures during the accumulation phase can be significant from an administrative perspective as well as a market acceptance perspective. Administratively, plan sponsors and recordkeepers will need to have the QJSA waiver and consent forms on record for as many as 40+ years as well as provide the necessary disclosures to comply with the requirements of §401(a)(11) and §417(a). Many of these products have had difficulty gaining momentum in the market place due to their complexity and difficulty in administration. Any additional administrative requirements that were not anticipated resulting from this PLR will undoubtedly mute market acceptance even further.

The Labor and Treasury departments

On the heels of this PLR is the joint Request for Information (RFI) by the departments of Labor and Treasury regarding "Lifetime Income Options for Participants and Beneficiaries in Retirement Plans." Both Labor and Treasury are interested in promoting retirement security and the welfare of the American workforce as many baby boomers enter their retirement years. One of these agencies' goals is captured in the introductory section of the RFI:

> *"The Agencies are considering whether it would be appropriate for them to take future steps to facilitate access to, and use of, lifetime income or other arrangements designed to provide a stream of income after retirement. This includes a review of existing regulations and other guidance and consideration of whether any such steps would enhance the retirement security of participants in retirement plans, taking into account potential effects on and tradeoffs involving other policy objectives."*

Specifically, two such questions are posed by the agencies to better understand the administrative complexities of the current QJSA rules and how those rules will interact with recent product development effort by the insurance industry. They are:

> *"26. Could or should any changes be made to the rules relating to qualified joint and survivor annuities and spousal consents to encourage the use of lifetime income without compromising spousal protections?*
>
> *27. Should further guidance clarify the application of the qualified joint and survivor annuity rules or other plan qualification rules to arrangements in which deferred in-plan insurance annuities accumulate over time with increasing plan contributions and earnings?"*

How respondents answer the two preceding questions, as well as the RFI itself, requires both detailed attention to specific regulations and administrative procedures combined with an overall view of the DC marketplace and a determination of how DC balances will provide retirement security for clients.

The past and the future

Past thinking about the DC marketplace and DC plans by insurance companies and service providers has been devoted to accumulation potential. Further, plan sponsors and plan participants likewise have viewed their DC balances as primarily accumulation vehicles. For the typical participant who retires today, approximately 20% of their overall wealth and retirement security will be provided by their retirement DC balance.[1] This perception is fueled by an abundance of calculators and planning tools that help participants achieve their overall savings goal by focusing on "a number."

What's missing are tools that help participants understand how their number translates into income, and tools that let participants know when they have the right target to begin with. Additionally, knowing your number provides no resolute alternatives should you eventually fall short of that number.

[1] Ghilarducci, Theresa; The End of Retirement, May 2006.

A view into the future points toward protection of accumulated balances within the DC marketplace by using stable value funds, continued proliferation-of-life cycle funds, and other preservation-of-principle investment vehicles as well as accumulation toward a guaranteed retirement income. By offering an income guarantee inside the DC plan, participants will know how much income their savings will transition into when they reach retirement with the confidence of being guaranteed a minimum income.

Development surrounding accumulation guarantees and investment funds with imbedded downside protections is poised for growth and acceptance in the market as a next generation product line in the DC industry.

Conclusion

Whether DC plans remain primarily accumulation vehicles or morph into personalized DB plans will either be helped or hindered by the guidance provided by the departments of Labor and Treasury as a result of this RFI is unclear. What is clear is that Americans will become increasingly responsible for their own retirement security. Insurance companies and other service providers will continue to provide innovative product designs and protections to enable participants to have income for life, and protections against certain retirement risks such as inflation risk, market risk, long-term disability risk, longevity risk, and the like. The question that remains is whether these protections, annuities, and income guarantees, which are very popular in the individual annuity market, will predominantly remain in the individual markets; or, if the DC market service providers and regulatory agencies will attempt to infuse a policy shift and enable these protections, guaranteed income, and annuities to be instituted inside the DC account balances. This would change the DC industry from an accumulation vehicle to an accumulation and deaccumulation vehicle. Both a regulatory shift and a market sentiment shift will be needed to accomplish the latter.

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