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IRS Revenue Ruling Clarifies the Use of Deferred Annuities in Retirement Plans

With the continued shift away from defined benefit pension plans and toward defined contribution plans such as 401(k)s, the investment management process has become even more stressful as participants worry about outliving their retirement savings.

On February 2, 2012, the Treasury Department published proposed regulations designed to address some of these concerns by encouraging the use of lifetime income annuity products. (Please see Ascensus' February 2012 *Washington Pulse* for a discussion of the regulations http://www.ascensus.com/pdfs/WashingtonPulseQLAC.pdf.) Along with the proposed regulations, the IRS issued two revenue rulings that explain how the new rules will affect existing annuity requirements when employers offer lifetime income options under their plans.

Annuity Requirements

Both defined benefit and defined contribution plans are generally subject to a rule that requires distribution to a participant in the form of a qualified joint and survivor annuity (QJSA). A QJSA ensures that participants receive lifetime annuity income and that the surviving spouse continues to receive annuity payments after the first spouse dies. Other forms of payment, such as periodic distributions and lump-sum distributions may be permitted with spousal consent after a detailed notice has been provided. If a married participant dies before QJSA payments begin, payments must be made to the participant's surviving spouse in the form of a qualified preretirement survivor annuity (QPSA) unless this option was properly waived.

The QJSA/QPSA rules, alternatives, notices, and consent requirements are complex. Fortunately, a "safe harbor" exception to the QJSA/QPSA rules exists for 401(k), stock bonus, and profit sharing-only plans because such plans were originally created primarily to supplement pension income rather than provide the primary source of retirement income.

Annuity Safe Harbor Requirements

Stock bonus, 401(k), and profit sharing plans will not be subject to the notice and consent rules referred to above if they meet *all* of the following conditions.

1. At death, a participant's vested benefit must be payable to the spouse (or other beneficiary if not married, or if the spouse consents to the alternative beneficiary designation).
2. A participant cannot elect a life annuity payment.
3. Transfers from another plan that is subject to the annuity requirements (e.g., a money purchase pension plan) must be accounted for separately and must remain subject to the annuity requirements.

The vast majority of stock bonus, 401(k), and profit sharing plans today are annuity safe harbor plans for two simple reasons. First, since defined contribution plans have largely replaced defined benefit plans, participants have become accustomed to controlling their retirement accounts rather than electing guaranteed annuity payments. Second, the annuity requirements are complex, so employers often don't want to bother with them.

To address these issues and encourage the use of annuity products in defined contribution plans, the IRS has issued Revenue Rulings 2012-3 and 2012-4 in addition to its proposed regulations.

Revenue Ruling 2012-3

Revenue Ruling 2012-3 makes it easier for employers to offer certain deferred annuity investment options without giving up the safe harbor relief. Specifically, Rev. Rul. 2012-3 provides a detailed example of a 401(k) plan that satisfies conditions #1 and #3 (as stated previously) to be an annuity safe harbor plan. The plan permits participants to select from a variety of investments, one of which is a deferred annuity contract that provides life annuity payments beginning the later of age 65 or at retirement. Before the annuity start date, a participant may freely move contributions into and out of the contract—as with any other investment in the plan—and the participant retains the right to receive a lump-sum distribution from the contract before the annuity starting date if there is a distribution event. If no other distribution option is selected, the default payment is a life annuity.

The ruling clarifies that the participant has not elected a life annuity merely by investing in a deferred annuity contract that *could* result in life annuity payments. Only if the participant fails to elect another form of payment will the life annuity payout take effect. At that point, the QJSA requirements apply to the annuity contract. Therefore, the annuity safe harbor feature of the plan still applies, meaning that the employer has provided a lifetime income option under its plan without undertaking the administrative burden of the annuity notice and consent requirements. In addition, most if not all of the annuity notice requirements would be satisfied by the insurance company at the time annuity payments begin, and, if the plan tracks assets by investment and contribution source, then only that portion of the account that is annuitized is subject to the QJSA annuity notice and consent rules.

By contrast, if the annuity contract permitted only life annuity payments, then the participant would be considered to have elected a life annuity and the amount invested in the contract would be subject to the annuity requirements immediately, even if actual annuity payments do not begin until a later date.

Revenue Ruling 2012-4

Some employers offer participants both a defined benefit plan and a 401(k) plan. Instead of offering life annuity options to participants within the 401(k) plan, which could create cumbersome notice and consent obligations, an employer could offer low-cost annuities under its defined benefit plan. Until now, employers were unsure about whether they could offer such annuities—and how to offer them. Revenue Ruling 2012-4 clarifies that an employer may allow participants in the defined contribution plan to directly roll over eligible amounts to the defined benefit plan in exchange for an immediate annuity from the defined benefit plan. Purchasing this lifetime income stream with assets that are rolled over to the defined benefit plan accomplishes two important goals. First, it gives the defined contribution plan a simple way to remain an annuity safe harbor plan. Second, it gives participants the flexibility of choosing an annuity payout option that may not be available from the defined contribution plan. When converting the rollover amount to an annuity, Rev. Rul. 2012-4 requires the defined benefit plan to use the same actuarial assumptions that the plan would use to convert annuity benefits to lump-sum payments.

Conclusion

Although more guidance has been promised, it appears that the federal government is nudging participants and employers towards a shift in how they approach the distribution phase of retirement. Service providers and employers should begin planning for the flexibility that some plan participants will expect as additional income planning guidance is released.