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Annuitizing From § 401(a) Defined Contribution Plans: A Technical Overview

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Introduction

Retirement plan planning literature is replete with information regarding the ''DB-ification'' of defined contribution (DC) plans, demonstrating a growing interest in providing a guaranteed lifetime income stream from these types of plans. A number of insurance companies have designed specific annuity products to meet this need; some plans are purchasing ''off the shelf'' annuity products to achieve the effect; and mutual fund companies are designing withdrawal programs which attempt to replicate these annuity benefits.

The following report is a technical overview of the legal issues involved in purchasing annuities for the purpose of providing insurance income guarantees from DC plans. It will not address the issues related to non-insurance based systematic withdrawal programs, as ultimately only insurance contracts can provide a lifetime guarantee of income. Nor will it discuss the unique legal issues associated with the use of annuity contracts as ongoing investment vehicles in DC plans.

The report does, however, address issues beyond the mere provision of guaranteed income. One of the benefits of using a DC plan to provide ''income benefits'' is the flexibility DC plans provide in supporting a whole new generation of annuity products available in the marketplace. Where defined benefit (DB) plans are locked into providing a straight life annuity, perhaps with some cost of living escalators, and perhaps with some lump sum options, DC plans are able to take advantage of the wide range of so-called ''living benefits'' that are now available, as well as some measure of death benefits that a DB plan could not otherwise provide.

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There are structural issues involved in providing DB-type benefits in a DC plan. First and foremost of these is the issue of contribution limits. There are separate Internal Revenue Code § 415 limitations for DB plans and DC plans. Providing a ''DB- like'' benefit from a DC plan suffers from the availability of only the DC limit. This has the odd policy result of limiting the availability of guaranteed lifetime income. Other structural issues include the manner in which the spousal consent rules apply and ambiguity with which certain tax qualification rules apply to the ''qualified plan distributed annuity.''

Key elements of annuity contracts

It is important for the plan sponsor to understand the key elements of annuity contracts in order to make an informed choice of what to offer through the plan. The proper plan design is driven in part by the sort of income guarantees the plan intends to provide.

Basics of the annuity contract. An annuity contract, as intimidating as it may look, is merely a contract which rests upon the general principles of contract law, and is governed by many of the same rules that apply to any other type of contract.[1]. What is different about the annuity contract is its regulated nature: it contains terms necessary to address specific state insurance laws and (where applicable) federal security laws. Included, for example, may be matters that relate to accounting and investment practices, solvency, special agency rules, and rules that govern the handling of premiums. What is common in all of these contracts is that, though there may be a number of ''non-insurance'' features such as variable investment funds, they all are designed to provide a guaranteed income stream over a named person's (or persons') lifetime [2]

The use of ''non-insurance'' features in annuity contracts is key to their flexibility. The most important non-insurance feature is the variable separate account, which has similar characteristics ''to a very substantial degree'' to the characteristics of mutual funds.[3] These separate account features enable insurance companies to design hybrid products which combine the features of accumulation guarantees with the guarantee of lifetime income.

It is important to recognize that there are limitations on the ability to negotiate the terms of an annuity contract. This is because the terms of an annuity contract are subject to review and approval by state insurance authorities. Though the amount and type of review will often vary with the type of contract, no annuity contract can be issued in a state without prior approval (or ''deemed'' approval) of the state. This means that changes to a state approved annuity contract generally must also be submitted to the state for approval, unless the state has granted prior approval making a particular term ''amendable'' without its prior consent.

A plan purchasing annuities will be faced with the decision of whether to purchase individual annuity contracts or group contracts. Each has its advantages: individual annuity contacts are easily made portable, and the individual records are kept within the contract itself. Group annuity contracts, on the other hand, are more easily integrated into a plan's administrative system, and often offer more advantageous pricing. The Employee Retirement Income Security Act[4] and the U.S. tax code[5] both permit the insurance contracts to be held outside of a trust (e.g., by the company or by the participant) but these arrangements are very unworkable for plan fiduciaries because such contracts are out of their effective control. Annuity contracts within the plan should be held, whenever possible, by the plan's trustee or custodian.

Living benefits. Annuity contracts are well-known for their ability to provide a standard variety of joint and survivor annuities, either over a stated term or for an annuitant's lifetime. Within a DC plan, these annuities can be purchased by a single premium or periodically over time. These are discussed more fully below.

Annuities have changed dramatically, however, over the past decade. Sophisticated hedging strategies have enabled insurance companies to bring innovative products to the market which are designed to address a number of concerns that have made simple annuitization relatively unpopular. Annuity contracts now can provide a number of so-called ''living benefits.'' These are guarantees which may be of interest to DC plans, as they serve to protect assets and guarantee minimum income while allowing continued exposure to the equity markets. Examples include, but are not limited to, features such as:

- variable annuitization, which provides lifetime income while giving the policyholder equity participation;
- guaranteed minimum account values (GMAB), which lock in investment gains over a period of time;
- guaranteed minimum withdrawal benefits (GMWB), which guarantee the ability to withdraw at least a certain amount over a set period of time, regardless of underlying equity performance;
- guaranteed minimum income benefits (GMIB), which insure the purchase of a minimum income stream beginning at a certain time, regardless of underlying equity performance; and
- a guaranteed lifetime withdrawal benefit (GLWB), which insures the ability to withdrawal benefits at a minimum level for a lifetime.

There are a variety of iterations, rules, restrictions, and expenses related to each of these products, depending upon the insurance company offering them. Each should be reviewed for its appropriateness for the plan. However, these living benefits in a DC plan are treated in the same manner as the annuitization, and the rules outlined herein can be applied equally to these benefits.

Death Benefits. A cautionary note is necessary on the provision of death benefits under annuity contracts. As discussed further below, the provision of an annuity contract under a DC plan is treated as an investment under the plan. To the extent that the annuity contract also provides for a death benefit that may be greater than the surrender value of the policy, the tax code's incidental benefit rules will apply. Though death benefits may be available under a traditional contract, it is of particular concern with some of the living benefits described above. These contracts will often have features called ''guaranteed minimum death benefits''(GMDB) and ''enhanced guaranteed minimum death benefits''

[1] Law and the Life Insurance Contract, Muriel L. Crawford and William T. Beadles, 1989, Richard D Irwin, Inc.

[2] Crouch on Insurance 2d (Rev'd), § 81:1.

[3] SEC v. The Variable Annuity Life Insurance Co., 359 U.S. 5 (1959).

[4] 29 U.S.C. § 1103.

[5] 26 U.S.C. § 401(f).

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(EGMB), which may trigger the life insurance rules applicable to DC plans.

Critical terms for annuities in DC plans. Annuity contracts are generally designed to be specifically marketed to targeted groups of customers, with particular features included to serve the financial needs of certain customers. This means that some annuity contracts contain terms that are designed with a DC plan's needs in mind, while a (much larger) number of annuities are designed for individual purchase. It is therefore prudent to review the specifics of a contract's terms to determine its suitability for the design of a particular DC plan. Features to be aware of include the following:

■ *Benefit sensitivity*. Determine whether the withdrawal and transfer rules, governing distributions from the contract are consistent with the terms of the plan document. This is important particularly in many of the forms of ''hybrid'' annuitizations and with living benefits, where an account balance is maintained along side an annuitization guarantee.

■ *Surrender charges*. Determine whether any surrender charges or market value adjustments are applied against amounts withdrawn from the contract in accordance with the terms of the plan.

■ *''Lock-ups.''* Look for terms which do not permit withdrawals under any circumstances, or for restrictions on transfers to or from any investment accounts in the contract.

■ *General account restrictions*. If a guaranteed account is available under the contract, make sure you understand any specific provisions related to the handling of these funds upon termination (including the crediting rate in case a ''stretch'' payment period is required).

■ *Annuitization assumptions*. Review the assumed interest rate (AIR) upon which the annuity payout is based, and find what percentage of the premium will be paid out annually.

■ *Portability*. Determine whether the contract can be transferred to the participant without additional charges in the event the participant decides to take a distribution of the annuity from the plan. The distribution of an annuity is discussed in more detail below.

■ *Reporting and disclosure*. Look for assurances that the insurance company has the ability to fully report the information needed to complete the Form 5500, including schedules A, C, H and I, and to comply with the Department of Labor regulations related to fee disclosure.[6]

■ *Expenses*. There is tremendous variation in the fees charged under an annuity contract for the package of financial services it provides. Though they may take the form of asset charges (called ''mortality and expense charges'' for registered products) if there is an account balance, they also may be built into the assumed interest rate of the contract. It is important to seek an explanation of contracts' expenses.

Plan Structure and Administration

Structuring a DC plan to provide annuitization is a straightforward task once a plan sponsor decides what it wishes to offer. The key risk to avoid is the risk of unintentionally transforming the DC plan into a DB plan. Improperly structuring this benefit could result in plan disqualification, and potentially cause a plan sponsor to become liable for a DB type of funding. The following plan terms and procedures should be reviewed and considered when designing a DC annuitization.

Plan investment language. The purchase of the annuity guarantee needs to be structured as a directed investment of the plan participant, as opposed to a benefit option under the plan. The plan's investment language should be drafted as broadly as possible both to accommodate the purchase of an annuity as an investment, and to allow various ways in which premiums can be paid. In particular, care should be taken to insure that the plan language does not prevent the following purchases:

■ *Single premium purchase*. Annuity guarantees can be purchased in a single, lump sum premium (or a series of such purchases) in anticipation of an immediate or deferred payout. This is type of purchase is most likely to occur at the time the participant expects to begin drawing regular payments from the annuity held by the plan, or as the participant is electing the distribution of a plan distributed annuity. It is also what would occur in an ''integrated'' program, where the annuity's design is closely integrated with the rest of the investments of the plan.

■ *Periodic premium purchase*. A few annuity products in the marketplace permit the plan participant to purchase small portions of a guarantee over a period of time, for example, with a portion of each payroll deposited to the DC plan. It appears this option is being used with increasing frequency, as various regulatory proposals have been floated from time to time to grant certain fiduciary relief to employers who purchase a ''portion'' of an annuity guarantee as a default investment for their DC plans.

Distribution language. Guaranteed payment programs are typically designed as payouts made after separation from service, serving as a ''stand-in'' for traditional pension payments. Though it is possible to design programs which permit a variety of ''in-service'' withdrawals, these can be an administrative nightmare and cause penalty taxes underI.R.C. § 72(t). This guide contemplates only payments from the plan which would not be subject to the 10 percent tax penalty under § 72(t).

The plan language should reflect the two ways in which annuity guarantees that have been accumulated or purchased under the plan can be distributed as retirement payments:

■ *Periodic payments directly from the plan*. The plan language should reflect the ability of the plan participant to draw periodic payments from the investments in the participant's accounts upon the occurrence of a distributable event under the plan. Caution should be used in allowing only distributions that are outlined in § 72(t)(2), so that the distributions are not subject to the 10 percent additional tax on early distributions. Plan sponsors should be particularly careful of the ''new generation'' annuity products, as some of the designs may fall outside of the exception from the additional tax for ''substantially equal payments'' under § 72(t)(2)(A)(4).

■ *Distribution of a ''qualified plan distributed annuity'' (QPDA)*. This occurs whenever a participant's account balance is used to purchase an immediate or a deferred annuity, either at the time of distribution or over time under the plan. The value of a QPDA is that it makes it makes the insurance guarantees purchased under the plan ''portable,'' allowing the participant to

[6] 72 Fed. Reg. 70,995 (December 13, 2007).

take those purchased guarantees with him rather than having to leave them behind win the plan.

For plan language purposes, the QPDA is an in-kind, lump sum distribution of an annuity contract, which should not be confused with the election of an ''annuity payment.'' The QPDA distribution can be made under the normal terms of a plan document which permit lump sum distributions (as long as the lump sum distribution is not limited to a cash distribution), or can be made upon the termination of the plan, if the terms of the plan so allow. These distributed annuity contracts can have a cash surrender value, upon which the participant will not be taxed until withdrawal from the annuity.[7]

Fiduciary processes. The choice of an annuity contract to provide guaranteed income under a DC plan governed by ERISA Title 1 is a fiduciary act, whether it is treated as a plan investment or whether it is to be distributed as a QPDA. The fiduciary standards that apply will differ, however, depending on whether the annuity is to remain part of the plan or whether it is to be distributed as a QDPA.

With regard to a purchase of an annuity that is to stay within the plan, Title 1 imposes no additional obligations other than those of prudence that apply to any other investment purchased by the plan. Purchasing and distributing a QPDA, on the other hand, imposes a more demanding fiduciary standard. The Department of Labor opined in Adv. Op. 2002-14A that the rigid rules that applied to choosing annuities for distribution under a defined benefit plan (often referred to as the ''safest available annuity rule'') were equally applicable to the choosing of annuities for distribution under defined contribution plans. Congress mandated in the Pension Protection Act[8] that the DOL alter this stance and draft different rules to apply to distributing annuities under DC plans. As a result, the DOL issued proposed regulations outlining standards for determining how these sorts of annuity contracts could be selected.[9]

Spousal consent. It appears that the election to annuitize from within the investments in a DC plan may trigger the spousal notice and consent rules under I.R.C. § § 401(a)(11) and 417, though it is not entirely clear. As of mid-2008 the IRS had yet to opine on the matter, so for the present it may be judicious to comply with the spousal consent rules in the event a participant elects annuitization in any other form than those required by the qualified joint and survivor annuity rules.

The regulations do make it clear, however, that the payment of a QPDA cannot be used to avoid the spousal consent rules.[10] The timing of the spousal consent appears to depend upon the type of QPDA chosen. If a participant chooses the distribution of an immediate annuity from the plan, the spousal consent rules should apply at the time of that election. Should a deferred annuity be chosen, it appears that the spousal consent would be required at the time of actual annuitization.

Portability: The Qualified Plan Distributed Annuity (QPDA)

One of the biggest challenges facing plan sponsors is how to handle the portability issue. The issue is how to deal with ''lifetime guarantees'' purchased with a portion of a DC account balance when something happens to the plan, such as the employer terminating the plan, the plan changing vendors and ceasing the purchase of any of these products, or any other of a number of plan-related transitions that can occur. Similarly, the plan must deal with both the plan participants who seek to sever relationships with their former employer's plan and take their guarantees with them and the employees who choose to take a distribution of an annuity contract from the plan.

The QPDA is the solution to the portability concern. A QPDA is ''an annuity contract purchased for a participant, and distributed to the participant.''[11] As noted, it is an in-kind, lump sum distribution of an annuity contract-- not to be confused with an ''annuity payment,'' which is the actual payout from an annuity. It has been in existence for most of the past century, as it is the legal vehicle underlying terminal funding annuities distributed from terminating DB plans.

The QPDA contract distribution can be made under the normal terms of a plan document which permits lump sum distributions (as long as the lump sum distribution is not limited to a cash distribution), or can be made upon the termination of the plan, if the terms of the plan so allow. Just a portion of the participant's account in a defined contribution plan can be used to purchase an annuity; the entire account balance does not have to be used. This is a critical feature in the design of annuity programs under DC plans, as participants can choose to make annuitization a part of an overall financial plan involving their plan balances.

Distribution of a QPDA is *not* a rollover and is neither reported, nor treated for tax purposes, as such.[12] The QPDA is the payment of the balance to the credit of the employee for purposes of I.R.C. § 402(c),[13] and is treated as if it were a part of an ongoing plan.[14] Taxation to the participant occurs only when, and to the extent, that payments are actually made from the contract.[15]

Though the QPDA annuity has been around for a long time, it has seen infrequent use in the DC world. As such, its application to DC plans lacks much of a formal, governing regulatory structure. There remains a bit of clarification needed on a number of rules. The IRS has suggested that all of the tax rules governing qualified plans will continue to apply to the QPDA, with the insurance company then necessarily fulfilling the role of plan administrator.

The regulations themselves have only dictated a handful of specific rules which must apply. The proposed contract should be reviewed for compliance with the following:

[7] Treas. Reg. 1.402(a)-1(a)(2).
[8] Pension Protection Act of 2006, Pub. L. No. 109-280, Section 625(a).
[9] 72 Fed Reg 52,021 (Sept. 12, 2007).
[10] Treas. Reg 1.401(a)-20, Q&A-2.

[11] Treas. Reg 402(c)-2, Q&A 10(a).
[12] *See* Instructions for Forms 1099-R and 5498, at 10.
[13] Treas. Reg. 1.402(c)-2 Q&A 10(b).
[14] I.R.S. GCM 39,882 (May 27, 1992).
[15] Treas. Reg. 1.402(a)-1(a)(2).

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■ The contract must be nonforfeitable and nontransferable.[16]

■ QPDAs can accept rollovers from, and can roll their funds into, qualified plans, IRAs, and other QPDAs, and must provide for direct rollovers.[17]

■ Any spousal rights and benefits under § § 401(a)(11) and 417 which may have arisen under the distributing plan cannot be eliminated by the distribution of a QPDA.[18]

■ The minimum distributions rules attributable to 401(a) plans apply to the QPDA, and the insurance company has the affirmative duty to force the minimum distribution out of the contract.

There are a few other rules applicable to a QPDA, including:

■ The distribution of the QPDA is reported on 1099-R, but no withholding is required as it is not a taxable event. The 20 percent withholding requirement applies to distributions from the QPDA in the same manner as if it were made from a qualified plan.

■ The prohibited transaction rules under I.R.C. § 4975 do not apply, which is important because it means that the investment advice restrictions do not apply.[19]

■ There is no requirement of filing an annual report or registration on the Form 5500.

■ The QPDA issued from an ERISA plan will not be governed by ERISA, though the plan's choice of an annuity provider will be.[20]

■ The § 402(f) notices (related to informing plan participants of the tax effect of the distributions) need not describe the tax effects of a QPDA.[21]

■ The QPDA is not covered by PBGC termination insurance, as it is not a plan as defined in ERISA § 3(2).

Conclusion

We can expect the rules governing annuitization from DC plans to evolve as the practice becomes more widespread. There are a number of practical questions which exist, many that involve finding a way in which to seamlessly integrate these insurance products into mutual fund based DC plans. The basic structure, however, is well in place and workable today.

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[16] I.R.C. § 401(g) (defining ''annuity''); *see also* Treas. Reg 1.402(c)-2 Q&A 10(a).

[17] Treas. Reg. 1.402(c)-2, Q&A10(b).

[18] Treas. Reg 1.401(a)-20, Q&A-2.

[19] *See* definition of ''Plan'' under I.R.C. § 4975(e).

[20] *See* DOL Advisory Opinions 2003-05A (April 10, 2003) and 1999-08A (May 20,1999)(citing ordinary notions of state property law in determining whether assets constitute plan assets.

[21] Treas. Reg. 1.402(f)-1.