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DISTRIBUTING ANNUITIES FROM DEFINED CONTRIBUTION PLANS: THE QUALIFIED PLAN DISTRIBUTED ANNUITY

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Qualified Plan Distributed Annuity (QPDA) contracts are financial instruments which are unfamiliar to most retirement law practitioners and consultants. They are a hybrid type of product, looking like a combination of an IRA and a qualified plan-while being neither. The key, discerning element to these products is the lack of continued employer involvement or responsibility for proper ongoing administration. They have been around as long as have defined benefit plans, but seeing only limited "service" in the defined contribution market. That, however, is about to change.

Two changes in the retirement plan marketplace are forcing new attention on the use of the QPDA in connection with defined contribution plans. First, the demise of defined benefit plans are causing employers and financial service companies to seek new ways to allow DC plan participants to choose a DB type of benefit. A number of companies have designed annuity products to address this market need, and the QPDA is necessary in order to make these benefits somewhat "portable." Being issued to an individual, it gives the participant the ability to continue with certain insurance guarantees even in the absence of an individual's ongoing relationship with an employer sponsored plan. Secondly, the new 403(b) regulations permit the distribution of a "fully paid individual annuity insurance contract" upon plan termination, which then forces the need for a regulatory scheme to support such contracts.

The 401(a) QPDA

Picture the traditional workforce of years past, where defined benefit plans reigned supreme and where workers were guaranteed a steady lifetime income. Employers who terminated these plans could (as they still can today) fulfill these retirement obligations by purchasing annuities for the participants' accrued benefit, and could then distribute these annuities to those participants. The plans' obligations disappeared, and retirees would now deal directly with the insurance company which issued the annuities, rather than the plan or the employer. Those receiving these annuities were not taxed on the distribution of the annuity contract, paying taxes only as amounts were distributed from the contract.

Fast forward to today's world, where defined benefit plans are in serious demise and defined contribution plans are in ascendancy. This dramatic shift has not, however, changed the need for retirees to have some sort of guaranteed lifetime income lest their longevity causes them to exhaust their savings. Employers are seeking a way to fill this gap, and financial service companies are designing a new generation of products designed to permit plan participants the ability to convert a portion of their defined contribution plan savings into guaranteed retirement income.

As long as these products are held by a plan, and provided from a plan, all is well and good. If care is taken, the current regulatory schemes will permit the properly structured DC program to provide a measure of lifetime guarantees. But one of the biggest challenges facing financial product designers is how to handle the "portability" issue. What happens to "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 transitions which can occur related to a plan? Similarly, what happens when a former employee seeks to sever relationships with their former employer's plan, but has purchased guarantees within that plan?

One answer, oddly enough, can be found in the old defined benefit world. In the same manner that a "lifetime income guarantee" could be distributed from a defined benefit plan as noted above, such lifetime guarantees (as well as any attendant account balances) can be made portable by the issuance of an annuity contract: the QPDA.

<u>What is a QPDA?</u>

A QPDA is "an annuity contract purchased for a participant, and distributed to the participant."[1] The annuity contract which is purchased by the plan and distributed to the participant does not have to be what is called an "immediate annuity," that is, it does not need to provide for the immediate payment of lifetime benefits. The annuity contract can have a cash surrender value, upon which the participant will not be taxed until withdrawal from the annuity.[2] This means that a contract with variable investment accounts can qualify as a QPDA, even without any payments being immediately payable from the contract.

A QPDA, in the context of a 401(a) DC plan, is an in-kind, lump sum distribution of an annuity contract, not to be confused with the election of an "annuity payment." An annuity payment distribution option from a plan (instead of the lump sum payment of a QPDA) provides periodic payments from the plan itself; it is not the distribution of an annuity. The QDPA 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. 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 need to be used.[3] This is a critical feature when designing annuity programs under DC plans, as participants can choose to make annuitization a part of an overall financial plan involving their plan balances.

The insurance contract must be an annuity contract, not a life insurance contract.[4]

[1] Treas. Reg. § 1.402(c)-2, Q&A 10(a).
[2] Treas. Reg. § 1.402(a)-1(a)(2).
[3] Treas. Reg. § 1.401(a)9-8, Q&A 3.
[4] *See* Treas. Reg. § 1.402(c)-2, Q&A 10(a).

The distribution of a QPDA is not a rollover, and is neither reported as such nor treated for tax purposes as such.[5] The QPDA is the payment of the balance to the credit of the employee for purposes of 402(c).[6]

What qualified plan rules govern the QPDA?

What is striking about the QPDA is the lack of a formal, governing regulatory structure. The IRS has suggested[7] 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, however, have only dictated a handful of specific rules which must apply:

- The contract must be nonforfeitable and non-transferable.[8] This is actually a critical point, and any contract which is used for these purpose must specifically contain these terms in order to obtain favorable tax treatment.

- QPDAs can accept rollovers from qualified plans, IRAs and other QPDA, as well as being able to roll funds from it into these other vehicles.[9]

- A QPDA must provide for direct rollovers.[10]

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

- The minimum distributions rules attributable to 401(a) plans apply to QPDA-not the IRA minimum distribution rules (which are different than the qualified plan distribution rules).[12] One of the critical differences is that the insurance company has the affirmative duty to force the minimum distribution out of the contract, unlike under an IRA.

- The distribution of the QPDA must be reported on 1099-R, but no withholding is required as it is not a taxable event.[13]

- 20% withholding requirement applies to distributions from the QPDA in the same manner as if it were made from a qualified plan. The payor is considered the plan administrator for these purposes.[14]

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[5] *See* Instructions for Forms 1099-R and 5498 at 10, *available at* http://www.irs.gov/pub/irs-pdf/i1099r.pdf (last visited Apr. 10, 2008).
[6] Treas. Reg. § 1.402(c)-2, Q&A 10(b).
[7] I.R.S. G.C.M. 39,882, (May 27, 1992).
[8] I.R.C. 401(g) (defining "annuity"); s*ee also* Treas. Reg. § 1.402(c)-2, Q&A 10(a).
[9] Treas. Reg. § 1.402(c)-2, Q&A 10(b).
[10] Treas. Reg. § 1.401(a)(31)-1, Q&A 17.
[11] Treas. Reg. § 1.401(a)-20, Q&A 2.
[12] Treas. Reg. § 1.401(a)(9)-6, Q&A 4.
[13] *See* Instructions for Forms 1099-R and 5498 at 10, *available at* http://www.irs.gov/pub/irs-pdf/i1099r.pdf (last visited Apr. 10, 2008).

- There is no requirement of a filing of an annual report or registration, Form 5500.

- The prohibited transaction rules under Code Section 4975 do not apply, which then means that the Code's and ERISA's investment advice restrictions do not apply. It also means that a number of financial transactions that cannot be accomplished under IRAs or qualified plans may be possible. It is important to note, however, that there are a series of rules applicable to annuity contracts which will need to be taken into account, as well as other state and federal rules related to investment advice and security transactions.

Application of the entire range of tax qualification rules to a QPDA appears to have little practical effect beyond the rules noted above, as the QPDA cannot take ongoing contributions. There are several questions, however, which remain open because of the lack of a comprehensive scheme. The most pressing of these are questions related to whether or not a loan can be taken from a QPDA. Logic would say you could as long as all plan rules related to loans apply, but the IRS has been reluctant to accept that position.

Will ERISA apply to the QPDA?

The QPDA, if issued as an individual annuity contract in the participant's name, will not be governed by ERISA (if otherwise issued from a plan governed by ERISA Title 1) because it is treated as a distribution of a plan asset.[15] There are, however, two instances in which ERISA is implicated.

- The purchase of the annuity contract. The purchase of a QPDA by a plan fiduciary for distribution to a plan participant is a discretionary act to which ERISA's fiduciary rules apply. The need for sensible rules governing the purchase of the QPDA was the driving force behind the eventual passage of the Congressional dictate to the Department of Labor in the Pension Protection Act. The DOL issued proposed regulations, outlining standards by which to determine the manner in which annuity contracts could be chosen.[16]

- The issuance of a QPDA as a certificate from a group contract. A QPDA does not necessarily need to be issued in the form of an individual contract issued in the name of the participant. It is possible for it to be issued as a "certificate" issued from a group annuity contract held by the plan. The question arises, which is yet to be answered by the DOL, as to whether (and to what extent) Title 1 would apply to these sorts of arrangements. It appears that much will depend upon the actual design of the underlying annuity contract, and how the design of the contract measures against the DOL's notion

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[14] Treas. Reg. § 31.3405(c)-1, Q&A 13.

[15] *See* DOL Advisory Opinions 2003-05A (Apr. 10, 2003) and 1999-08A (May 20, 1999) (citing "ordinary notions of [state] property law" apply in determining whether assets constitute plan assets or individual beneficiaries' property).

[16] (Prop. Reg.) Selection of Annuity Providers for Individual Account Plans, 72 Fed. Reg. 52,021 (Sept. 12, 2007).

of property rights.[17] If the plan is seen as having little, if any, property rights, the QPDA certificate is likely not to be considered a plan asset.

<u>How do Federal Security Laws impact the QPDA?</u>

A participant's account balance invested in variable accounts within a retirement plan which is qualified under Code Section 401 is generally considered (but for a few notable exceptions) an "exempted security"[18], which means that the interests in the typical defined contribution plan are not required to be registered under the Securities Act of 1933. This is truly a limited exception, as this relief does not apply to variable interests in 403(b) plans.

The QPDA raises the 33 Act question, some of which are not yet answered, that is, at what point is the QPDA subject to registration under the Act. There are certain things that we do know:

- We know that a fixed annuity contract, or one with only fixed investment benefits, is not required to be registered.[19] This means that issuing a QPDA with an immediate, fixed payout, or one in which there is only a guaranteed fund within the contract, can be issued without regard to registration requirements.

- We also know that a QPDA in which the interests of employees are involuntary made and non-contributory will also not be considered a security[20], which likely means that a forced distribution of a QPDA as a terminating distribution from a profit sharing plan need not be registered.

- We also know that a QPDA issued "in connection" with a plan that meets the tax qualification requirements of 401 will be an exempted security.[21] The question, however, is under what circumstances will a contract be considered as being issued "in connection" with the plan as opposed to being the voluntary purchase of a variable security. On one end of the spectrum is the issuance of a QPDA certificate from a non-registered group annuity contract owned by a plan, where registration requirements are unlikely. The other end of the spectrum would involve the purchase and issuance of individually owned variable QPDAs. It is likely that the SEC would resist a claim that these sorts of individual contracts need to be registered.

Whether or not a QPDA needs to be registered is a critical issue for financial service companies which create these products, as the requirements of registration affects the flexibility and expense underlying these products. It will also affect the manner in which these products can be distributed, and the manner in which compensation is paid. Product sponsors

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[17] *See* DOL Advisory Opinions 2003-05A (Apr. 10, 2003) and 1999-08A (May 20, 1999).
[18] Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77c(a)(2).
[19] Securities Act of 1933 § 3(a)(8), 15 U.S.C. § 77c(a)(8).
[20] *International Brotherhood of Teamsters v. Daniel*, 99 S.Ct. 790, 439 U.S. 551 (1979).
[21] Securities Act of 1933 § 3(a)(2).

will have liability should they fail to properly comply with the SEC's rules. From a plan sponsor's view, familiarity with this issue will likely be a piece of their own fiduciary review.

The 403(b) QPDA

The IRS has raised the question of the applicability of the QPDA rules for 403(b) plans by the issuance of its new 403(b) regulations. Those regulations lay out an entirely new scheme of plan administration related to these plans, which relies heavily upon employer involvement. The regulations also permit employers, for the first time, to terminate a 403(b) plan and to distribute its assets. In terminating these plans, employers are able to make a distribution of "fully paid individual insurance annuity contracts"[22] to plan participants. These "fully paid" contracts maintain their status as 403(b) contracts, even though there is no longer any employer involvement. This means that these regulations have created a 403(b) version of the QPDA, where the responsibility for the proper administration of the contract will lie with the issuer of the 403(b) contract.

There are several points which differentiate a 403(b) QPDA from the 401(a) QPDA. Most importantly, all of the published guidance to date only references 401(a) plans, and is premised upon the 401(a) tax qualification rules. There is no such guidance for 403(b) QPDA. Unlike 401(a) QPDAs, however, there existed an entire framework under the "pre-reg" 403(b) arrangements under which QPDA-type of arrangements have been effectively administered, arrangements which relied solely upon the 403(b) product vendor and the individual contract owner. The employer played little, if any, role in the administration of these contracts. It is highly likely that product vendors will turn to these "pre-reg" rules to define their responsibilities, even without the regulatory guidance necessary to make such activity work. Interestingly enough, it is this sort of activity which should form the basis of working out many of the heretofore undefined rules for the proper administration of the 401(a) QPDA.

An unusual twist for the 403(b) QPDA is the existence of 403(b) custodial accounts. The new 403(b) regs seem to contemplate that a custodial account (which is deemed to be an annuity contract under the 403(b) rules) could serve as a QPDA, something which is not possible under the current 401(a) guidance. It will be interesting to see how the IRS resolves this particular issue.

Summary

The QPDA has languished in the background for many years, its greatest use in the past being associated with the termination of defined benefit plans. With the growing need for providing portable retirement income benefits, and with the demands forced by the new 403(b) regulations, these hybrid products will enjoy growing prominence in the retirement plan regulatory scheme. This increased focus should ultimately result in a more highly organized regulatory approach to these products

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[22] Treas. Reg. § 1.403(b)-10(a)(1).