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IRS Guidance facilitates annuitization of retirement benefits

Recent guidance will ease restrictions and clarify certain rules in order to encourage the provision of annuities, including both "longevity annuities" in defined contribution plans and partial annuity options in defined benefit plans, and encourage the selection of such options by participants.

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The Treasury Department and the Internal Revenue Service ("IRS") have released a package of guidance intended to facilitate the provision of annuities in qualified retirement plans. The package includes two sets of proposed regulations and two Revenue Rulings. The first of the proposed regulations would amend the minimum required distribution regulations to enable defined contribution plan participants to purchase so-called "longevity annuity contracts" with a portion of their accounts. The second proposed regulation would make it easier for defined benefit plans to offer bifurcated distribution options, whereby participants could elect to take their benefit partially in cash and partially in an annuity. One of the Revenue Rulings clarifies the spousal consent rules for defined contribution

plans when the plan permits participants to invest their accounts in deferred annuity contracts; the other provides guidance on rollovers from an employer's defined contribution plan to the employer's defined benefit plan in order to provide an annuity payout. A Treasury Department Fact Sheet on the new guidance and a report from the Council of Economic Advisers on "Supporting Retirement for American Families" were also released as part of this package.

With the decline in qualified defined benefit plans and their replacement by defined contribution plans, such as 401(k) plans, employees covered by qualified retirement plans are less likely to be eligible for a guaranteed stream of income for their lifetime after retirement. When defined benefit plans offer optional payment in the form of a



cash lump sum rather than a traditional annuity, retirees tend to elect to receive the lump sum. As a result, many retirees may be at risk of outliving their savings, particularly in view of the advances in life expectancy over the past decades.

Recently, Treasury and the IRS have released proposed regulations and other guidance that would facilitate the provision of lifetime income from qualified retirement plans, by addressing a number of perceived problems. The package includes guidance:

- Intended to make it easier for plans to offer combination distribution options, such as the option to take a portion of the participant's benefit as a stream of payments over life, while taking the remainder as a lump sum or other option.
- Enabling plans and IRAs to offer "longevity annuities", permitting participants to use a portion of their accrued benefit to provide a guaranteed lifetime income beginning at a later age, such as 80 or 85, without running afoul of the minimum required distribution requirements.
- Clarifying the rules for transfers of benefits from an employer's defined contribution plan to their defined benefit plan in order to receive an annuity from the defined benefit plan, and

- Clarifying the joint and survivor annuity and spousal consent rules when a defined contribution plan permits investment in a deferred annuity.

Bifurcated Payment Options under Defined Benefit Plans

Under the Internal Revenue Code ("Code"), defined benefit plans must provide benefits in the form of a qualified joint and survivor annuity. Except for certain small benefits, the present value of the accrued benefit may be distributed only if both the participant and the spouse of the participant consent in writing to the distribution. The present value of the benefit must be calculated using actuarial assumptions set forth in Code Section 417(e). This is known as the minimum present value rule. Under an exception to the minimum present value rule, the value of the qualified joint and survivor annuity and other annuity options, if applicable, is generally calculated utilizing plan factors, which may be different from the factors under Section 417(e). The exception applies to a distribution paid in the form of an annual benefit that doesn't decrease over the participant's lifetime, or that decreases merely because of the death of the participant's spouse or the end of a social security supplement or qualified disability benefit. The 417(e) factors must be used to determine the actuarial equivalency of any other form of

payment of the participant's accrued benefit under the plan.

The proposed amendment to the regulations under Section 417(e) would provide a new exception to the minimum present value rule for plans that provide partial annuity distribution options, called in the proposal a bifurcated accrued benefit. Under such a plan, participants are given the choice of electing different distribution options with respect to separate portions of their accrued benefit. The proposed regulations would provide that the two different distribution options will be treated as two separate optional forms of benefit. Thus, the exception from the minimum present value requirements for nondecreasing annuity options would apply to the portion of the distribution that consists of a nondecreasing annuity, and the minimum present value requirements would apply to the remaining portion of the participant's accrued benefit.

The proposed amendment to the regulations sets forth several different ways in which plans may offer a bifurcated benefit with separate payment options, and provides helpful examples illustrating these rules.

Observation *The preamble to the proposed regulations explains that, absent this change, a plan that provides a bifurcated payment option to participants must utilize the assumptions under Section 417(e) to calculate both portions of the benefit.*

Following this change, plans may simply use the 417(e) assumptions for the single-sum portion of the optional form and their usual annuity equivalence factors for the annuity portion. For example, the plan would calculate the amount of the participant's entire accrued benefit in the form of the qualified joint and survivor annuity using the plan's equivalence factors, and would convert that benefit to a lump sum distribution using the 417(e) assumptions. If the participant elected to receive 75% of his benefit in the form of a qualified joint and survivor annuity and 25% in cash, the plan would provide an annuity equal to 75% of the previously calculated annuity amount, and would pay 25% of the previously calculated lump sum amount in cash.

Longevity Annuity Contracts from Defined Contribution Plans

Longevity annuity contracts are deferred annuities that begin at an advanced age. Such contracts might help defined contribution plan participants hedge the risk of drawing down their benefits from defined contribution plans and IRAs too quickly and outliving their retirement savings. Longstanding Treasury regulations under the minimum required distribution requirements are an impediment to using or offering longevity annuity contracts in qualified plans and IRAs. Under these rules, benefits must commence by the

required beginning date (April 1 of the year following the later of attainment of age 70-1/2 or the year the participant retires; April 1 of the year following the attainment of age 70-1/2 for 5-percent owners and IRA owners), and be paid over the lives of the participant and a designated beneficiary.

Under current regulations, the value of any annuity contract held under the plan that has not yet been annuitized is included in the account balance used to determine the required minimum distribution each year. Each year's distribution must be no less than a proportion of the account balance, including the annuity contract, calculated to spread the account balance over the remaining lifetime of the participant and beneficiary. Where an annuity contract is part of the account, it is possible that the cash in the account could be used up before the date on which the deferred annuity is to begin, with nothing remaining from which to make distributions.

The proposed amendment to these regulations would modify the required minimum distribution rules in order to facilitate the purchase of deferred annuities that begin at an advanced age up to age 85. Prior to annuitization, the value of such "qualified longevity annuity contracts" ("QLACs") would be excluded from the account balance used to determine minimum required distributions.

To constitute a QLAC, a contract would be subject to certain rules under the proposed regulations, including:

- The cumulative premium paid for the contract may not exceed the lesser of \$100,000, indexed, or 25% of the employee's account balance on the date of the premium payment.
- The maximum age at commencement of the annuity is 85.
- The only permissible death benefit payable from the QLAC is a life annuity payable to a designated beneficiary upon the employee's death. The life annuity payable to the employee's surviving spouse may not exceed 100 percent of the annuity payable to the participant; a life annuity payable to a nonspouse designated beneficiary may not exceed an applicable percentage of the employee's annuity amount under the regulations.
- The contract must satisfy certain other QLAC requirements, including that it may not include a variable contract, an equity-indexed contract or a similar contract, nor may it have any cash surrender value.
- QLAC issuers are required to provide certain disclosure and annual reports to be filed with the IRS and furnished to the individual

in whose name the contract is purchased.

In addition to qualified plans, the proposed regulations would apply to IRAs, 403(b) plans and eligible governmental Section 457(b) plans. Because Roth IRAs are not subject to the lifetime minimum distribution rules, the proposed regulations would not apply the rules regarding QLACs to Roth IRAs, although they would be permitted to purchase longevity contracts. The proposed regulations also do not apply to defined benefit plans.

Application of Survivor Annuity Requirements to Deferred Annuity Contracts under a Defined Contribution Plan

Rev. Rul. 2012-3 addresses the qualified joint and survivor annuity ("QJSA") and qualified preretirement survivor annuity ("QPSA") rules under a defined contribution plan that offers deferred annuity contracts as a participant-directed investment option under the plan. A defined contribution plan is exempt from the QJSA and QPSA requirements if:

- the plan provides that vested accrued benefits are paid in full to the participant's surviving spouse (or, if none, to a designated

beneficiary) on the death of the participant,

- the participant does not elect a payment of benefits in the form of a life annuity, and
- the plan is not a direct or indirect transferee of a plan that was subject to the QJSA and QPSA requirements with respect to the participant.

The ruling discusses a plan that permits a participant who elects to invest in a deferred annuity contract to transfer amounts invested in the contract to another investment option prior to commencement of benefits or to elect a single-sum payment under the contract. In this situation, the plan satisfies the exception from the QJSA rules, because the entire vested benefit is payable to the spouse upon the participant's death, and the participant has not elected an annuity form of payment simply by investing in the annuity contract. However, at the annuity starting date, if the participant has not elected another form of payment, the participant becomes subject to the QJSA requirements with respect to the annuity contract. Because the plan separately accounts for the deferred annuity contract, it is not subject to these rules with respect to the balance of the participant's account.

For a plan that restricts a participant who invests amounts in a fixed deferred annuity contract from subsequently

transferring those amounts out of the contract and does not permit the participant to elect to take those amounts in the form of a single-sum payment, the plan is subject to the QJSA and QPSA rules with respect to benefits under deferred annuity contracts beginning when the participant first invests in the contract. At that time, the participant has elected an annuity form of payment, so the exception from the QJSA and QPSA requirements no longer applies.

The ruling also discusses the circumstances when a written QPSA explanation and spousal consent to waive the QPSA would be required.

Rollover from Defined Contribution Plan to Defined Benefit Plan to Obtain Additional Annuity

Rev. Rul. 2012-4 considers the rollover of a participant's benefit under an employer's qualified defined contribution plan, such as a 401(k) plan, to the employer's qualified defined benefit plan, in order to obtain a larger annuity. Amounts rolled over from one plan to another are treated as mandatory employee contributions and must be fully vested. Under this ruling, the defined benefit plan provides an annuity resulting from the direct rollover determined by converting the

amount directly rolled over into an actuarially equivalent immediate annuity using the 417(e) factors. This plan satisfies the Code requirement that a participant's own contributions be nonforfeitable, and the benefit resulting from the direct rollover is excluded from the participant's annual benefit for purposes of the limitations on annual benefits under Code Section 415.

If, however, the plan were to use a less favorable actuarial basis than the rates under Section 417(e), the plan would not satisfy the vesting requirements under the Code. By contrast, if the plan were to use a more favorable actuarial basis (such as a higher interest rate or a mortality table with shorter life expectancies) in calculating the annuity value of the amount rolled over, the extra portion of the annuity is not treated as a benefit derived from the employee's own contributions. In that case, the excess is included in the annual benefit under the Section 415 limits, is subject to the non-discrimination rules, and may cause the employer to have additional funding costs. Furthermore, if the plan becomes subject to the funding-based limitations of the Code because the plan's funding ratio falls below 60%, then rollovers in this case would not be permitted, as they would give rise to additional benefit accruals that would not be permitted under Code Section 436.

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