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Retirement Income in Defined Contribution Plans

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Introduction

- Recent change in focus in DC plans
  - Other than money purchase or target benefit plans
  - From accumulation to decumulation
  - Changing role of 401(k) plan
- Impact of SECURE Act and SECURE 2.0 Act of 2022
- Concern about long-term future of Social Security

Plan Sponsor Concerns

- Employers may be reluctant to offer annuity options because
  - Distrust of the annuity industry
  - The costs and fees associated with annuities
  - Difficulty to perform the legally independent investigation of the annuity product
  - Confusing and complicated provisions within the annuity contract

Lifetime Retirement Income Background

- 2010 RFI by DOL and IRS
- Soliciting information on how retirement security of participants in DC plans might be enhanced by facilitating access to and use of lifetime income arrangements designed to provide a lifetime stream of income after retirement
  - Provided much comment and discussion, but no concrete actions
- Plan participants in DC plans generally were not pressing 401(k) plan sponsors for an annuity option at that time
  - If participant was interested in lifetime income stream, participant could accomplish that outside of the DC plan by a rollover into an IRA

SECURE Act

- SECURE Act sought to encourage retirement income in DC plans in three ways
  - A new safe harbor for selecting annuity provider
  - Lifetime income disclosure
  - In-plan annuity options

Safe Harbor

- SECURE Act added new ERISA Section 404(e)
  - Optional safe harbor for the prudent selection of guaranteed retirement income contract ("GRIC")
- GRIC defined as "an annuity contract for a fixed term or a contract (or provision or feature thereof) that provides guaranteed benefits, for at least the remainder of the life of the participant or the joint lives of the participant and the participant's designated beneficiary as part of an individual account plan"
  - Annuity selected can be inside or outside the plan

Safe Harbor

- Background of new ERISA Section 404(e) was 2008 DOL regulation §2550.404a-4
- Set forth steps a plan fiduciary should take when prudently selecting a benefit distribution annuity option for an individual account plan
  - Engage in an objective, thorough, and analytical search to select a provider
    - Same principles would apply to the selection of any service provider to a plan
  - Appropriately consider information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract
    - Plan fiduciaries concerned about meaning of "appropriate consideration: and "all future payments"

Safe Harbor

- Appropriately consider the cost (including fees and commissions) of the annuity contract in relation to the benefits and services provided
- Appropriately conclude that, at ‘the time of selection’ the annuity provider is financially able to make all future payments under the contract and that the cost of the contract is reasonable in relation to the benefits and services to be provided
- Time of selection defined to mean either
  - The time that the annuity provider and contract are selected for purposes of contemporaneously distributing benefits to a specific participant or beneficiary
  - The time that the annuity provider is selected to provide annuity contracts at future dates to participants or beneficiaries

Safe Harbor

- Important proviso to "time of selection"
  - Selecting fiduciary must periodically review the continuing appropriateness of the conclusion that the provider is financially able to make all future payments under the contract
  - That the cost of the contract is reasonable in relation to the benefits and services provided
- Fifth condition of 2008 DOL safe harbor was, if necessary, consult with appropriate expert(s) for purposes of compliance with the above provisions
  - Accurate statement of what the duty of prudence requires, but its subjective nature made fiduciaries uncomfortable

Safe Harbor

- Under 2008 DOL safe harbor, the selection of a service provider to select an annuity option treated the same way as any other investment option
- Under ERISA, a fiduciary is personally liable for any losses to a plan participant resulting from a breach of fiduciary duty
- Concern: A provider that seemed financially sound at the time of the selection might decades later fall into a financially troubled state, and with the benefit of hindsight, there might be something that a plaintiff’s attorney could point to that was not discovered during the period of monitoring
- For these reasons, little fiduciary activity undertaken to satisfy the 2008 DOL regulatory guidance

Safe Harbor

- To address these concerns, Congress added a safe harbor based on the language in the 2008 DOL guidance, although eliminating the fifth condition: the need to hire an expert if needed
- New SECURE Act safe harbor had two main principles:
  - Consider the financial capacity of the insurer to satisfy its obligations under the contract
  - Consider the cost of the contract in relation to the benefits and products features of it and the administrative services to be provided under such contract

Safe Harbor

- With respect to establishing the financial capacity of the annuity provider, the insurance company is required to make written representations that
  - The insurer is licensed to offer guaranteed investment annuity contract
  - The insurer, at the time of the selection and for each of the immediately preceding seven plan years
    - Has operated under an active certification of authority from its domiciliary state
    - Has filed audited financial statements according to the laws of the its domiciliary state under applicable statutory accounting principles
    - Has maintained reserves that satisfy all statutory requirements of all states in which the insurer does business
    - Is not operating under an order of supervision, rehabilitation, or liquidation

Safe Harbor

- At least ever five years, the insurer undergoes a financial examination by the insurance commissioner of the domiciliary state
- The insurer will notify the fiduciary of any change in circumstances related to any of the above items that would preclude the insurer form making such representations at the time of issuance of the GIAC

Safe Harbor

- Similar to 2008 DOL safe harbor, the relevant fiduciary must "periodically review" the continued appropriateness of its conclusions regarding the financial capability of the insurer
  - Fiduciary deemed to perform a periodic review if it receives the written representations previously discussed, unless it receives notice of, or otherwise becomes aware of, facts that would cause the fiduciary to question the insurer's representations
- Takeaway: Fiduciary selecting the service provider does not need to perform its own financial analysis of the insurer's financial ability to comply

Safe Harbor

- With respect to cost, the fiduciary is not required to select the lowest contract
- Fiduciary may consider the value of the contract relative to the cost
- Basis for assessing value may consider the features and benefits provided under the contract
- In addition to considering the contract itself, fiduciary may consider attributes of the insurer
    - Consideration of an insurer's financial strength is mentioned specifically

Safe Harbor

- If fiduciary complies with its other fiduciary responsibilities pertaining to the selection of the insurer and the guaranteed investment annuity contract, there is no requirement to review the appropriateness of a selection after the purchase of the contract
- SECURE Act explicitly states that a fiduciary in compliance with the requirements outlined in the safe harbor is not liable for any losses resulting from the insurer's inability to satisfy its obligations under the terms of the GIAC

Safe Harbor

- Plan fiduciaries should consider using the safe harbor when adding retirement income products to DC plans
- SECURE Act safe harbor much easier to satisfy than 2008 DOL guidance
  - Financial wherewithal of insurance company only needs to be examined at the time of selection
  - Representations from the insurance company regarding its financial capacity to pay claims can be relied upon

Lifetime Income Disclosure

- SECURE Act 203 amended pension benefit statement rules under ERISA Section 105
- Requires individual account plans to add a lifetime income disclosure to at least one pension benefit statement furnished to participants during a 12-month period
- Lifetime income disclosure must express a participant's total accrued benefit as a lifetime income stream
- Monthly payment amounts that a participant or beneficiary would receive if account balances were applied to provide a lifetime income stream, determined based on DOL assumptions

Lifetime Income Disclosure

- Two sets of lifetime income streams are required
  - Single life annuity
  - Qualified joint and survivor annuity, based on spouse of same age
- Lifetime income disclosures required even if plan does not offer lifetime income illustration options

Lifetime Income Disclosures

- Must be written in a manner calculated to be understood by the average plan participant and include
  - The statement period beginning and ending date
  - The participant's account balance as of the last day of the statement period
  - Expressed as a lifetime income stream payable in equal monthly installments as
    - Single life annuity
    - Qualified joint and survivor annuity

Lifetime Income Disclosure

- In interim final rule, the DOL prescribed a set of assumptions to be used when converting a participant's account balance to a single life and qualified joint and survivor annuity
  - Annuity start date is last day of the benefit statement period
  - Age at annuity starting date is age 67, or actual age if older than 67
  - Future growth in account is not included
  - Spouse is of equal age, regardless of spouse's actual age
  - Qualified joint and survivor annuity benefit provides a 100% survivor benefit

Lifetime Income Disclosure

- Interest rate assumption is a 10-year constant maturity Treasury rate as of the first business day of the last month of the statement period
- Mortality: Unisex mortality as described in Code Section 417(e) for DB plans
- Account balance includes outstanding loans not in default

Lifetime Income Disclosure

- Lifetime income disclosures must explain the annuity illustrations
- DOL provided model language for these explanations in interim final rules, including:
  - An explanation that the monthly payment amounts are illustrations only
  - An explanation that the actual monthly payments that may be purchased will depend on numerous factors and may vary substantially from the illustrations
  - An explanation that the monthly payment amounts are fixed amounts that would not increase for inflation
  - An explanation that the monthly payment amounts are based on total benefits accrued, regardless of whether such benefits are nonforfeitable

Portability

- Portability in the DC plan context, refers to the ability to move an annuity out of a DC plan within which it was purchased
  - Prior to SECURE Act, in-plan lifetime income products were difficult to administer
  - Such products have features that may be supported by only one or a few investment platform providers
  - If plan sponsor elected to move to a new investment platform, this annuity option might be lost
  - If plan lifetime income products cannot easily be substituted
  - Forcing a participant to liquidate to move to a substitute investment option could result in a significant loss of value to the participant

Portability

- Participant generally could not elect to remove the annuity option from the plan
  - Distributions from tax qualified DC plans can only be made at specified times or under specified circumstances
  - Even if a participant could receive a distribution, it was questionable whether such a product could be rolled over into a new plan
    - If plan participant could not roll over the lifetime income product, the participant, if he/she had not attained age 59-1/2, could be subject to a 10% early withdrawal penalty
- If a plan wanted to maintain the accumulated lifetime income option and switch to a new recordkeeper, it would then have two recordkeepers

Portability

- Problem addressed by SECURE Act Section 109
- Added new Code Section 401(a)(38) to allow DC plans to include provisions allowing, on or after the date that is 90 days prior to the date that is no longer authorized to be held as an investment under the plan to either
  - Qualified distributions of lifetime income investments, or
  - Distributions of a lifetime income investment in the form of a qualified plan distribution annuity contract
- Similar provisions were made to 403(b) plans and governmental 457(b) plans

Portability

- Lifetime income investment: a plan investment option providing participants with election rights (i) which are not uniformly available with respect to other investment options, and (ii) which relate to a lifetime income feature available through a contract or arrangement available under the plan
- Lifetime income feature is one which (i) guarantees a minimum level of income annually or more frequently for at least the remainder of the life of the participant or the joint lives of the participant and his or her designated beneficiary, or (ii) an annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments over the life of the participant or the joint lives of the participant and his or her designated beneficiary

Portability

- A qualified distribution is a direct trustee-to-trustee transfer to another eligible retirement plan as defined under Code Section 402(c)(8)(B)
- A qualified plan distribution annuity contract means an annuity contract purchased for a participant and distributed to the participant by a tax qualified plan, and 403(b) plan or a Code Section 457(b) plan for a government employee
- Takeaway: SECURE Act 109 allows an annuity that is removed from an investment option within a retirement plan to be rolled out of the plan without creating a taxable event for any affected participant or incurring the 10% early withdrawal penalty under Code Section 72

Fiduciary Considerations

- Plan fiduciaries should look at more than past performance and fees when considering lifetime income options
- Plan fiduciaries should also consider when lifetime income should be included in a plan's qualified default investment alternative
  - Is there a benefit to adding lifetime income options for younger participants and what are the consequences/costs?
  - What are the tradeoffs?
  - How does lifetime income impact the portfolio allocation?

Fiduciary Considerations

- When including a lifetime income feature within a plan's QDIA, relevant plan fiduciaries should consider:
  - Impact upon savings, especially around the time of retirement
  - Income received in retirement (guaranteed and not guaranteed)
  - Savings available for emergencies or to bequeath to a beneficiary
  - Portfolio characteristics
    - Expected returns, downside capture, etc.

Fiduciary Considerations

- Risk measures
  - Market risk
  - Inflation risk
  - Longevity risk
  - Cognitive risk
  - Liquidity risk

Lifetime Income Options

- Increasingly, plan sponsors considering whether to implement additional distribution and lifetime income investments
- Lifetime income investments have become a hot topic as they can provide a stable cash flow in retirement
- Plans implementing lifetime income options may require:
  - Plan amendments
  - Investment policy statement revisions
  - Document updates and participant communications regarding the new options

SECURE 2.0

- SECURE 2.0 made additional changes with respect to retirement income products in DC plans:
  - Increased the required minimum distribution date
  - Modified the qualified longevity annuity contract rules
  - Modified the limitations with respect to commercial annuities
  - Modified the rules with respect to partial annuitization

Required Minimum Distribution

- Unless a participant is a 5% owner of the plan sponsor, a DC plan can be drafted to provide, and generally does, that distributions are not required to commence until the employee retires
  - SECURE Act extended the RMD from age 70-1/2 to age 72
  - SECURE Act 2.0 extended the RMD from age 72 to 73 beginning in 2023
  - SECURE Act 2.0 further extended the RMD until age 75 in 2033
- While tax deferral is advantageous, deferral of distributions could mean increased taxed upon receipt of larger required minimum distribution

QLAC

- A longevity contract is a fixed or variable annuity that does not enter payout phase until annuitant reaches a specified advanced age (e.g., age 80)
  - At that point, a regular stream of payments begins
  - Contract may also offer other options
  - Right to surrender the contract for cash value
- Intended to mitigate the risk that a person living to a very old age will run out of money
- A QLAC is a specific form of a longevity contract
  - Concept introduced during the Obama Administration

QLAC

- QLAC is a deferred income annuity purchased by a transfer of a portion of an employee's account in a tax qualified DC plan
- A QLAC is not subject to the Code's RMD provisions
  - Caveat: If annuity payments for a year exceed the amount that would be required to be distributed under the individual account rules based upon the value of the annuity, the excess amount of the annuity payments can be applied towards the required minimum distribution for the year with respect to any remaining interest in the same plan

QLAC

- QLAC must satisfy certain provisions under IRS regulations, some of which were modified by SECURE 2.0 Act
  - Annuity payments must begin by the first day of the month following the annuitant's 85^{th} birthday
  - When issued, the contract must state that it is a QLAC
  - The periodic payments must be fixed
  - The contract cannot offer a commutation benefit, cash surrender value, or similar feature
  - Amounts paid after the annuitant's death must satisfy the incidental benefit rule under the regulations
  - The issuing insurance company must file annual reports on the QLAC with IRS and copy participants

QLAC

- Prior to SECURE 2.0 Act, the limitation on contract premiums was the lesser of an inflation adjusted dollar amount (155,000 in 2023), or 25% of the value of all traditional IRAs
  - SECURE 2.0 eliminated the percentage limitation, and increased the dollar limitation to $200,000 as indexed
  - Facilitates the sale of QLACs with spousal survivor rights
  - Clarifies that free look periods are permitted up to 90 days with contracts purchased or received in an exchange on or after July 2, 2014

Other Annuity Modifications

- Section 201 of SECURE 2.0 Act eliminated certain barriers to the availability of life annuities in tax qualified DC plans because of actuarial tests designed to limit tax deferral
  - Prior to amendment, even modest cost of living increases such as 1% or 2% were prohibited
- SECURE 2.0 exempts from actuarial testing certain types of benefits, such as annuity payments that increase by less than 5% per year, and the lump sum return of premium death benefits

Other Annuity Modifications

- Prior to SECURE 2.0 Act, if a DC retirement plan account held an annuity, for purposes of determining the RMD, the account had to be bifurcated
  - This could result in a higher RMD than if the participant's account did not hold an annuity
- Section 204 of SECURE 2.0 Act permits the account owner to aggregate the distributions from both portions of the account for purposes of determining RMDs

Conclusion

- Opportunities for DC plans to offer lifetime income investment options and to increase their portability has been enhanced by SECURE Act and SECURE 2.0
  - Some providers have had hybrid models for some time
  - Other providers working to create a platform that will allow plan sponsors to review and compare options that may be desirable for their plans
- Many details require clarification
  - A lot of guidance will be necessary and hopefully issued
- Takeaway: Changes made by SECURE and SECURE 2.0 make lifetime income options and certain types of plan investments more attractive to plan sponsors

QUESTIONS?