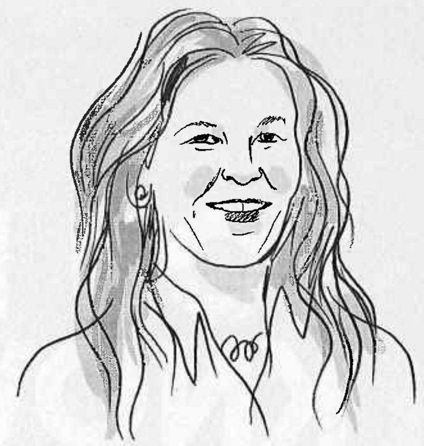

Attention to Details

Government debuts lifetime income initiatives *(cont.)*

IN MY LAST COLUMN, I began a discussion about the package of proposed regulations and immediately effective revenue rulings pertaining to lifetime income, released by the Internal Revenue Service (IRS) on February 2. In this column, I address the rest of the regulation and revenue rulings.

Educating participants and plan sponsors. Any effort to educate participants as to how longevity annuities can hedge against outliving their retirement assets will need to address not only the longevity risk but also the long-term viability of the insurance companies providing the annuity. Plan sponsors will also need to understand the added fiduciary exposure from their selection of an annuity provider. Existing Department of Labor (DOL) regulations consider the selection of an annuity provider a fiduciary act and require plan fiduciaries to conduct an "objective, thorough and analytical search for purposes of identifying providers from which to purchase annuities." A plan fiduciary may be required to hire a qualified independent expert, if the fiduciary lacks the appropriate expertise to make the selection. Before adding longevity annuities as a plan investment option, many plan sponsors may look for a reaffirmation that implementing a prudent process in the selection of an annuity provider will be sufficient to insulate them from fiduciary liability, should the insurer become insolvent

Split distributions. One aim of the proposed regulations is to eliminate impediments confronting plans that wish to offer split distribution options, such as an annuity or a lump sum. It is important to avoid forcing participants to make an all-or-nothing choice when it comes to these alternatives, because participants are reluctant to forgo the liquidity represented by the current availability to take cash.

The current rules do not prohibit split distributions, but they are complicated and can provide results that defy common sense. For example, where an optional form of benefit consists of a partial lump sum and a partial annuity, the current regulations under Section 417(e) of the Internal Revenue Code (IRC) require the use of statutorily prescribed interest and mortality factors for both portions. Accordingly, a plan would be unable to use its regular conversion factors to calculate the partial annuity—this means that the annuity portion of a distribution, split equally between the annuity and a lump sum, could be significantly more or less than one-half of the total annuity benefit. Under the proposed regulation, the statutorily prescribed factors would need to determine only the portion of the distribution being paid as a lump sum, thereby providing a more intuitive result.

Rulings encourage rollovers and clarify spousal consent. The Obama administration's regulatory guidance also included two revenue rulings that promote lifetime income options from defined contribution plans. Revenue Ruling 2012-4 encourages employers sponsoring both defined benefit and defined contribution plans to use their defined benefit plans as a way to offer lifetime income options for their employees' 401(k) account balances. Specifically, participants may be permitted to roll over their 401(k) balances to the defined benefit plan and convert them into an annuity under the plan. The advantage of this arrangement for participants is that they can easily annuitize their 401(k) benefit at favorable rates, rather than the rates otherwise available in the retail marketplace.

Another ruling clarifies how regulations relating to spousal death benefits apply to deferred annuities, such as longevity annuities. Revenue Ruling 2012-3 confirms that offering deferred annuities in a 401(k) plan will not accidentally trigger IRS death benefit rules requiring spousal consent. Under these rules, defined benefit plans must pay death benefits to a participant's surviving spouse in the form of a special type of annuity, unless the spouse opts out. Generally, 401(k) plans are exempt from these rules, as long as they provide for payment of the participant's account balance to the surviving spouse. Prior to this ruling, there was a concern that the spousal consent requirement might apply to a 401(k) participant who invested in a deferred annuity. The ruling clarifies the situations in which spousal consent will not be required before the annuity begins, thereby eliminating another obstacle for plan sponsors who want to use deferred annuities.

Many details regarding the IRS's regulatory package promoting lifetime income options remain in need of ironing out. In addition, the DOL must address the appropriate financial education of employees, and provide guidance on the process for selecting annuity providers. Other agencies will also be required to develop new rules. Thus, the coming months will see follow-up steps on the lifetime income project.

Marcia S. Wagner is an expert in a variety of employee benefits issues and executive compensation matters, including qualified and nonqualified retirement plans, and welfare benefit arrangements. A summa cum laude graduate of Cornell University and Harvard Law School, she has practiced for 24 years. Wagner is a frequent lecturer and has authored several books and numerous articles.

 Illustrations by Lauren Tamaki