Using Target Date Funds to Provide Lifetime Income

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Policymakers in the Obama administration favor using the power of inertia to encourage the selection of lifetime annuities as the form of benefit distribution in a 401(k) plan. Advocates of default annuities have developed proposals involving trial annuities from which plan participants would receive monthly income for a specified period during which they could opt out and take a lump sum. However, unless action is taken by the applicable deadline, periodic payments would become mandatory. Now, this concept is being applied in a different way.

The IRS and the DOL have recently issued coordinated guidance intended to facilitate defined contribution plan investments in a series of target date funds (TDFs) whose assets include deferred annuities that will pay lifetime benefits to retired participants. The guidance consists of:

- IRS Notice 2014-66 (the Notice), concluding that such annuities are not discriminatory benefits, rights, or features; and
- A DOL Information Letter to J. Mark Iwry (the DOL Letter), dated October 23, 2014, concluding that a TDF will not fail to qualify as a qualified default investment alternative (QDIA), even if it provides such an annuity.

IRS Ruling on Discrimination

The investment considered by both the IRS and DOL guidance involves a series of TDFs. Each TDF within the series is available only to participants who will attain normal retirement age within a limited number of years around the TDF's target date. As the TDF's age group attains age 55 (or some other specified age), deferred annuities will begin to be included in the fixed income component of the TDF's underlying assets. The deferred annuities are not issued to or owned by any specific individual participant; instead, they are written on behalf of the group of participants covered by that particular TDF. As the group's age advances, the portion of the TDF's portfolio applied to deferred annuities increases. Since the cost of an annuity varies with age, only participants within the TDF's designated age band (*e.g.*, ages 54–56) will be allowed to invest in a TDF holding annuities. TDFs in the series that are geared to younger participants would not hold annuity investments until the TDF's target age group reaches the specified age.

In the Notice, the IRS considered such a TDF series in connection with the nondiscrimination requirement for qualified plans. Under the nondiscrimination rules, benefits, rights, and features under a plan must be currently available to a nondiscriminatory classification of employees, and the group of employees to whom benefits, rights, and features are effectively available must not substantially favor highly compensated employees. If each TDF is viewed separately, then the TDFs that hold deferred annuities (which due to actuarial restrictions are available only to older participants) could be viewed as violating the current availability or effective availability requirement for benefits, rights, and features. The Notice, however, concludes that the TDF series as a whole is treated as a single right or feature for purposes of the benefits, rights, and features test, thereby allowing each TDF within the series to meet the nondiscrimination requirement.

The relief from the nondiscrimination rules is conditioned on the satisfaction of several requirements. Annuities with guaranteed minimum withdrawal or guaranteed lifetime withdrawal features are currently prohibited, although this could change. The TDF series must serve as a "single integrated investment program" and each TDF in the series must have the same investment manager and apply the same generally accepted investment theories across the series. In addition, the TDFs cannot hold employer securities that are not readily tradable on an established securities market. Each TDF in the series must be treated in the same manner with respect to rights or features, other than the investment mix. For example, the fees and administrative expenses for each TDF must be determined in a consistent manner.

QDIA and Fiduciary Issues

The DOL Letter analyzes whether a TDF series with annuity investments can be considered a QDIA and also addresses whether the annuity provider selection safe harbor under DOL regulations is available to cover the selection of the annuity provider by the TDF's investment manager. Under the QDIA rules, the plan fiduciary responsible for plan investments is liable as an ERISA fiduciary for the selection of the QDIA, but not for the results of a participant's investment in the QDIA. The DOL Letter confirms that so long as the TDF satisfies the requirements for a QDIA as specified in current regulations (including the furnishing of the required notice to participants), the use of deferred annuity contracts as fixed income investments will not cause a TDF to fail to meet the requirements of a QDIA.

The DOL Letter clarifies that when selecting annuity providers, the annuity selection safe harbor as currently provided in the regulations is

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available, and if satisfied, will insulate the TDF investment manager from fiduciary liability should the annuity provider become insolvent. Under the regulatory safe harbor, there are several requirements a fiduciary must satisfy, including performance of an objective, thorough, and analytical search for the annuity provider, as well as assessing the provider's ability to make all future payments under the annuity contract.

The DOL Letter also confirms that the fiduciary responsibility for choosing the annuity provider belongs to the TDF investment manager, not to the plan sponsor who appoints the investment manager. The investment manager must qualify as an ERISA Section 3(38) investment manager that acknowledges its fiduciary status. The investment manager must also be independent from the insurance company issuing annuities to the TDF. However, the sponsor would have the duty to monitor the investment manager and, although the DOL does not say so, this duty presumably includes periodically investigating the manager's annuity selection process.

Each TDF in the series is dissolved at its target date, at which time plan participants invested in that TDF will receive an annuity certificate representing the participant's interest in the group annuity contract held by the TDF, as well as the balance of the participant's interest in the TDF. The Notice indicates that the certificate will provide for immediate or deferred commencement of annuity payments, which presumably means that the annuity has been designed to automatically annuitize a premium deposit account at the target date. It is not clear if this auto-annuitization is a necessary condition for the favorable IRS and DOL treatment contained in the new guidance. If not, a participant would retain the ability to receive a cash distribution from the plan. If auto-annuitization is a required feature, participants who wish to receive a lump sum would need to move their plan investments out of the TDF before it reached its target date. ❖

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