RETIREMENT INCOME PRODUCTS IN DEFINED CONTRIBUTION PLANS

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INTRODUCTION

- Need to distinguish money purchase plans and target benefit plans from other defined contribution plans
  - While both are defined contribution plans, they are characterized under the Code as pension plans
  - Provide for at a minimum qualified joint and survivor annuities and qualified preretirement annuities
  - Lump sum option generally offered as optional form of benefit and selected as distribution option in money purchase or target benefit plans
- Other types of tax qualified plans, such as stock bonus or ESOP, less likely to consider offering annuity options

INTRODUCTION

- Threshold question is whether plan participant would be better served by rolling over his/her account balance to an IRA
- This was a primary focus of the DOL Retirement Security Rule
  - District Court decisions invalidating those regulations on appeal to Fifth Circuit
  - DOL has asked Fifth Circuit to pause appeal pending its review of Retirement Security Rule

INTRODUCTION

- Whatever outcome, participants separating from serve will have a decision whether or not to rollover
- Availability of retirement income options in defined contribution plans will be a factor to take into account
  - Other factors may include availability of private equity/cryptocurrency type investments in defined contribution plans

INTRODUCTION

- Recent change in the focus of defined contribution plans
- Shift in focus from the accumulation phase to the decumulation phase
- Change in focus attributable to
  - The changing role of 401(k) plans
  - Impact of SECURE and SECURE 2.0 of 2022
  - Concerns about the long-term future of Social Security
  - Longevity risk

INTRODUCTION

- RMDs for 5% owners of a plan sponsor
- RMDs for non-5% percent owners upon retirement
- RMDs for non-5% owners who have not retired upon their applicable retirement date if plan so provides
- systematic withdrawal provision
- managed account
- annuity option in QDIA target date fund
- purchase of annuity from carrier

ADDING RETIREMENT INCOME PRODUCT TO A DC PLAN

- Supreme Court and Department of Labor draw a distinction between settlor and fiduciary activities
- Settlor functions represent business decisions, not plan decisions
- Settlor activities include adopting a plan, amending a plan, terminating a plan, authorizing a merger or spinoff of a plan

ADDING RETIREMENT INCOME PRODUCT TO A DC PLAN

- Implementation of a settlor activity, such as implementing a settlor decision to add a retirement income product feature, would be a fiduciary function
  - Amending the plan to include the retirement Income product feature is fiduciary
  - Notifying participants by way of SMM or updated SPD is a fiduciary function

PRE-SECURE ACT IRS TECHNICAL GUIDANCE

- Prior to issuance of SECURE Act, IRS issued two revenue rulings to address technical issues with respect to lifetime income annuity options in defined contribution plans
  - Rev. Rul. 2012-3-four issues with respect to offering a lifetime income annuity option in a defined contribution plan
  - Rev. Rul. 2014-66- lifetime retirement income option under a target date fund

SECURE ACT

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

EDUCATION

- Lifetime income disclosure is one way of educating participants about potential benefits of lifetime income
  - Plan sponsors have the opportunity to provide education to employees about the potential benefits of lifetime income
  - Do not cross the line between education and recommendation
- Combination of education and availability of in plan lifetime income option may encourage workers to elect to have a portion of their plan assets invested in in plan annuity options
  - Average plan participant does not have a financial advisor to guide him or her in such matters

SAFE HARBOR

- SECURE Act added new ERISA Section 404(e)
  - Optional safe harbor for the prudent selection of a guaranteed retirement income contract (“GRIC”)
- GRIC defined as “an annuity contract for a fixed term or a contract (or provision or feature thereof) which 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 plan

SAFE HARBOR

- SECURE Act does not specify which annuity products could be offered within the defined contribution plan
  - A full spectrum of possible products- for a plan fiduciary to assess
  - One straightforward option would be to offer a single premium immediate annuity at retirement or a qualified longevity annuity contract(QLAC), which would commence either immediately or at some later date, such as age 85
  - Another option would be options of a similar nature that would be purchased while the employee is working

SAFE HARBOR

- Under 2008 DOL safe harbor, the selection of a service provider to provide an annuity option treated the same way as any other investment option
  - Subject to ERISA's duties of prudence and loyalty, and avoidance of prohibited transactions
- Under ERISA, a fiduciary is personally liable for any losses to a plan participant resulting from a breach of fiduciary duty

SAFE HARBOR

- Concern: A provider that seemed financially sound at 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
  - The initial selection can only be challenged as a breach of fiduciary duty within six years of the date of selection by relevant plan fiduciary
  - The 6-year statute of limitations under ERISA Section 413 is a statute of repose

SAFE HARBOR

- To address these concerns, Congress added a safe harbor based upon the language in the 2008 DOL guidance, although eliminating the condition from the 2008 DOL guidance of 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 its domiciliary state under applicable statutory accounting principles

SAFE HARBOR

- 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
- Some plan fiduciaries may believe that the safe harbor sets the bar too low, and a plan fiduciary could add additional conditions

SAFE HARBOR

- At least every 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 from 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 cost 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 income 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 SECURE Act safe harbor when adding retirement income products to defined contribution 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 OPTIONS

- Increasingly, plan sponsors considering whether to implement additional distribution and investment lifetime income investments
- 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 defined contribution plans
  - Increased the required minimum distribution date
    - While tax deferral is advantageous, deferral of distributions could mean increased taxes upon receipt of larger required minimum distribution
  - Modified the qualified longevity annuity contract rules
  - Modified the limitations with respect to commercial annuities
  - Modified the rules with respect to partial annuitization

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
- Intended to mitigate the risk that a person living to a very old age will run out of money

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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 85th 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
    - $210,000 in 2025
  - A lifetime limit on contract premiums, rather than an annual limit

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