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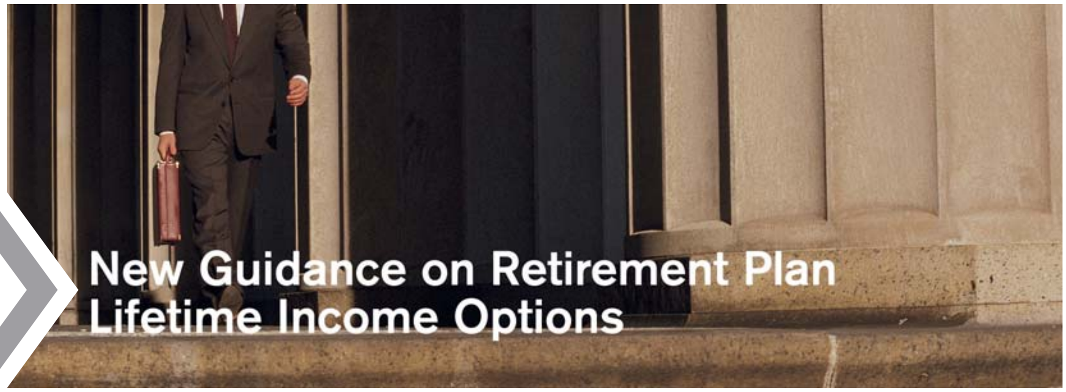

February 2012

A special report on New Guidance on Retirement Plan Options.

Executive Summary

The Treasury Department released guidance last week to encourage the use of annuity options in defined contribution and other retirement plans. This guidance is intended to encourage the availability of lifetime retirement income for participants in these plans. Although the guidance removes certain regulatory barriers and clarifies uncertainties in the law, it fails to address certain important legal and administrative issues that need to be considered before implementing these options.

New Guidance on Retirement Plan Lifetime Income Options Answers Some Questions, But Still Leaves Many Others Open

On February 2, 2012, the Internal Revenue Service ("IRS") and U.S. Department of Treasury ("Treasury Department") announced a much-anticipated guidance package intended to encourage the use of full and partial lifetime annuity options in defined benefit and defined contribution retirement plans. The package comes in the form of two proposed IRS regulations, which were published in the *Federal Register* on February 3, and two revenue rulings, which are set to be published in the *Internal Revenue Bulletin* on February 21. The guidance is the first step in a joint initiative between the Treasury Department and the U.S. Department of Labor ("DOL") to help increase savings and retirement income and to provide incentives for retirees to move away from the current trend of taking lump-sum retirement plan distributions instead of annuity distributions. The Treasury Department also issued a Fact Sheet that, among other things, describes how the current trend has resulted in the increased risk of Americans outliving their assets in retirement.

The new guidance removes certain regulatory impediments to offering lifetime annuity options and is intended to give retirement plan sponsors and fiduciaries greater certainty in administering their plans, as further explained below. At the same time, however, there are a number of issues that were not addressed by the guidance and need to be considered before plan sponsors take advantage of these new options.

Offering Partial Annuities in Defined Benefit Plans

One of the stated goals of the guidance is to make it easier for defined benefit retirement plans to offer combined retirement options, such as the option for plan participants to receive a portion of their benefits in the form of a lifetime stream of payments and the remaining portion in the form of a lump-sum cash payment. To encourage this option, the proposed IRS regulations would make it easier for defined benefit pension plans to calculate the value of a partial annuity form of benefit when it is offered in conjunction with a lump-sum benefit.

Current Regulatory Requirements. By way of background, Section 417(e) of the Internal Revenue Code ("Code") and the regulations thereunder generally mandate the method that tax-qualified defined benefit plans must use to calculate the present value of all optional forms of benefit. The present value of an accrued benefit and the amount of certain optional forms of benefit, including lump-sums, must not be less than the amount calculated using specified interest rates and mortality assumptions (this is commonly referred to as the "minimum present value requirement"). However, there is an exception in the regulations for annuity forms of payment – the value of different annuity options under a plan may be calculated by converting one type of annuity into another using the plan's regular conversion factors, rather than the more complicated minimum present value factors. Under current regulations, a defined benefit plan that offers a combined retirement option (i.e., a partial annuity and lump-sum option) is required to use the more complicated minimum present value factors for valuing the lump-sum portion and the partial annuity portion of the benefit.

New Proposed Regulations. The new proposed Section 417(e) regulations would provide an exception to the minimum present value requirement and allow plans offering a combined retirement option to use the simpler conversion factors for valuing the annuity portion of a benefit. Although the lump-sum portion of the benefit must still be calculated using the minimum present value factors, the Treasury Department hopes that by easing the burden of calculating combined retirement options, more plans will offer these options.

The new proposed Section 417(e) regulations would apply to distributions with annuity starting dates in plan years beginning after the publication date of final regulations. It is important to note that these proposed regulations would apply only to those defined benefit plans that choose to allow for bifurcated distribution options. Plans that previously provided partial lump-sum distribution options would be required to comply with the Code's anti-cutback provisions if they are amended to take advantage of the simplified conversion provisions in the regulation. Taxpayers wishing to comment on these proposed regulations have until May 3, 2012 to submit comments.

Offering Longevity Annuities in Defined Contribution Plans

Another stated Treasury Department goal is to address the concern for retirees outliving their retirement savings. To respond to this risk, the IRS issued proposed regulations that facilitate the use of qualified longevity annuity contracts ("QLACs") in certain types of defined contribution plans (described below) by modifying the current required minimum distribution ("RMD") rules under Code Section 401(a)(9). The theory underlying QLACs is to provide participants with the ability to take a portion of their account balance immediately at termination for short-term liquidity or other needs and still have a protected deferred annuity that would begin at a later age. With a QLAC, participants would have the protection of additional retirement income later in life in case they "outlive" their retirement savings.

Defining a QLAC. Under the proposed regulations, QLACs generally consist of annuity products purchased from insurance companies that meet the following six specific regulatory requirements:

1. Premiums for the QLAC could not exceed the lesser of 25% of the employee's account balance or $100,000. These amounts are adjusted for changes in the cost of living and for premiums paid under multiple QLACs for the same employee. For purposes of the $100,000 limit, amounts paid by the employee under any plan will count.
2. The QLAC would provide for distributions to start at some date in the future but not later than when the employee attains age 85.
3. The QLAC would provide for certain death benefit protections for surviving spouses and for nonspouse beneficiaries, as required by the rules under Code Section 401(a)(9).
4. The QLAC would not provide any commutation benefit, cash surrender right or similar benefit.
5. No benefits would be provided under the QLAC after the employee's death other than life annuities payable to designated beneficiaries.
6. The contract would have to state that it is intended to be a QLAC.

In addition to these requirements, insurers would be required to provide certain notices concerning benefits available under the QLAC. The insurer must create a report disclosing to the participant a number of items which generally explain the amount, timing and other features of the longevity annuity. The report would need to be furnished to a participant prior to or at the time of the annuity purchase. The proposed regulations also impose an annual reporting requirement on issuers of QLACs.

Current Regulatory Concerns. Because a QLAC would provide for an annuity beginning at a later age (such as age 85), the regulatory concern is that the deferred payments would cause the plan to violate the RMD rules. Under the RMD rules, a participant in a defined contribution plan generally must begin taking required minimum distributions by April 1 after the later of attainment of age 70½ or retirement. RMDs are based on the participant's life expectancy and plan account balance**.** If a plan participant uses a portion of his or her account balance to purchase a longevity annuity but ends up using too much of his or her remaining account balance for expenses, an RMD could become due with no liquid assets available to make the distribution. The Treasury Department stated that the risk of significant penalties for violating the RMD rules has limited the feasibility of offering deferred partial longevity annuities**.**

Proposed Regulatory Fix. The proposed regulations would solve the RMD problem for QLACs by excluding any amounts invested in QLACs from the determination of RMDs that must be made. In other words, RMDs would not be calculated by reference to or taken from amounts invested in QLACs. QLACs may be available under defined contribution plans, individual retirement accounts (IRAs), Section 403(b) annuities and certain eligible governmental Section 457(b) plans. The proposed regulations would not apply to defined benefit plans as they already provide for longevity protection in the form of lifetime annuities.

The proposed QLAC regulations would generally apply to contracts purchased on or after the publication date of final regulations. Comments on these proposed regulations also are due by May 3, 2012.

Using Rollovers To Purchase Annuities in Defined Benefit Plans

In addition to the partial annuity options and QLAC products, the Treasury Department sought to encourage lifetime annuity options by making it easier for defined benefit plans to accept rollovers from defined contribution plans in exchange for additional annuity benefits under the defined benefit plans. Essentially, this transaction is akin to purchasing an additional defined benefit plan annuity through a rollover of funds from a defined contribution plan upon an employee's retirement. Although this transaction is permissible under current law, the Treasury Department indicated that uncertainty in this area may have served as a barrier for many employers to offer this option under their plans.

Facts of the Ruling. To address this issue, the IRS released Revenue Ruling 2012-4 that is intended to provide a partial road map for employers to use if they wish to allow rollovers from defined contribution plans into defined benefit plans for the purpose of purchasing additional annuity benefits. The ruling examines how the rules apply in the context of a profit sharing defined contribution plan that is not subject to the joint and survivor annuity rules and does not accept after-tax employee contributions. It assumes that a participant in the profit sharing plan desires to roll over funds from the plan directly to a qualified defined benefit plan in order to convert that balance into an annuity (or additional annuity) from the defined benefit plan. Significantly, the facts of the ruling assume that the participant will commence the annuity distribution within a period of not more than 180 days after the date of the election. The defined benefit plan will credit the amount rolled over with interest at 120 percent of the Federal mid-term rate until the actual annuity starting date, calculate the annuity equivalent of the rollover amount using the applicable interest and mortality assumptions under Code Section 417(e), and provide death benefit protection for the rollover amount (plus interest) in addition to any death benefit otherwise provided by the defined benefit plan.

Legal Issues Presented. Based on the specific facts presented, two legal issues were raised**.** First, does the amount attributable to the rollover comply with the Code Section 411(c) rules requiring that benefits derived from employee contributions in a defined benefit plan be nonforfeitable? Second, does additional annuity provided by the rollover amount otherwise cause the defined benefit plan to violate the Code Section 415(b) annual limit (the limit is $200,000 for 2012) on amounts payable under defined benefit plans?

The IRS ruled that a qualified defined benefit plan that accepts a direct rollover of an employee's or former employee's benefit from a qualified defined contribution plan maintained by the same employer does not violate these rules if the defined benefit plan converts the rollover amount to an actuarially equivalent annuity by using the applicable interest rate and applicable mortality table under Code Section 417(e). The result is that the benefit attributable to the rollover amount is treated as nonforfeitable and would not count toward the annual benefit limit under Code Section 415(b).

However, if the defined benefit plan were to provide an annuity attributable to the rollover amount based on less favorable actuarial factors so that the annuity is smaller than otherwise required by law, then the plan would not be qualified. On the other hand, if the defined benefit plan were to provide an annuity attributable to the rollover amount based on more favorable actuarial factors, so that the resulting annuity is actually larger than otherwise required, then the portion of the benefit attributable to the rollover amount that exceeds the minimum legally required amount is essentially treated as a new employer-provided benefit and would have to comply with the qualification rules separately from the rollover amount.

Interestingly, Revenue Ruling 2012-4 only applies prospectively to rollovers that are made after January 1, 2013**.** However, plan sponsors are "permitted to rely on the holdings of this ruling with respect to rollovers made prior to that date."

Spousal Consent Rules and Deferred Annuities in Defined Contribution Plans

The fourth item of guidance provided by the IRS and Treasury Department is [Revenue Ruling 2012-3](), which relates to how the spousal consent rules would apply to a defined contribution plan that offered deferred annuity options, aside from any QLAC options described above. To analyze the issues, the IRS assumed that a 401(k) profit sharing plan with matching contributions offers an investment option under the plan in the form of a deferred annuity contract. The plan in question apparently does not allow for after-tax employee contributions and no part of the plan includes an employee stock ownership plan ("ESOP"). The terms of the deferred annuity contract generally provide that payments commence by the first day of the first month that begins after the later of the date the participant retires or attains age 65 (subject to an exception that provides for an earlier commencement date in the case of any participant who is a 5 percent owner and who retires after age 70½).

Background of Legal Requirements. Under Code Section 401(a)(11), defined contribution plans are only subject to the rules requiring a married participant's benefit to be offered in the form of a qualified joint and survivor annuity ("QJSA")[1] and a deceased participant's benefit in the form of a qualified preretirement survivor annuity ("QPSA")[2] if: (1) the plan does not provide that the participant's nonforfeitable benefit is payable in full, on the death of the participant, to the participant's spouse; (2) the participant elects a life annuity form of benefit payment; or (3) the participant's benefit does not include any amount transferred from a plan that was subject to the QJSA and QPSA requirements. A participant may waive the QJSA or QPSA forms of benefit, but only after the plan provides a written explanation of the rules and the participant's spouse consents to the waiver, in writing. The QJSA, QPSA and spousal consent requirements are referred to as the "Spousal Consent Requirements."

Applying the Spousal Consent Requirements to Deferred Annuities. Revenue Ruling 2012-3 assumes that the profit sharing plan in question is not otherwise subject to the Spousal Consent Requirements. Thus, the question is how those requirements apply to a participant who elects to invest a portion of his or her account in a deferred annuity product in three different scenarios. In the first scenario, the participant invests in an annuity contract under which the form of payment can be changed from an annuity option (e.g., into a lump-sum distribution) any time prior to the annuity starting date. In the second scenario, the participant is locked into the annuity form of benefit when the investment in the annuity contract is made and may not change the form of benefit. In

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1 A QJSA provides an annuity for the life of the participant with a survivor annuity for the spouse that is not less than 50 percent or more than 100 percent of the amount of the annuity payable during their joint lives, and that is actuarially equivalent to a single life annuity for the participant.

2 The spouse of a participant who dies prior to his or her annuity starting date is entitled to a QPSA – which is an annuity for the life of the spouse in an amount not less than 50 percent of the participant's nonforfeitable benefit.

addition, the plan provides a QPSA that is fully subsidized and may not be waived. The participant in the third scenario invests in a similar annuity contract, but in this scenario the plan allows a participant to waive the QPSA.

In the ruling, the IRS determined that:

- In the first scenario, the plan is not subject to the Spousal Consent Requirements with respect to the participant's deferred annuity contract until the annuity starting date because the participant may change the form of benefit up until that date.
- In the second scenario, the plan is generally subject to the Spousal Consent Requirements with respect to the annuity contract beginning when the participant first invests in the contract because the annuity form of benefit may not be changed. However, because the QPSA is fully subsidized and may not be waived, the plan does not need to obtain spousal consent with respect to the QPSA.
- In the third scenario, because the plan allows a participant to waive the QPSA, any waiver must include the spouse's notarized consent following a written explanation by the plan of the consequences of waiving the QPSA.

Significantly, the IRS clarified that in all three scenarios, because the plan separately accounted for the deferred annuity contract, the remainder of the participant's account balance was not subject to the Spousal Consent Requirements.

Unanswered Questions and Potential Problems

This new guidance on protecting retirement income undoubtedly will garner significant attention by plan sponsors, retirement plan providers and insurance companies interested in offering these new products. However, there are a number of open issues and unanswered questions raised by this guidance that must be considered before changing existing options. Among the issues not addressed by the guidance are the following:

- **Domestic Partner Issues.** The guidance on relaxing the RMD rules for QLACs could raise important questions for those 401(k) plans that try to provide benefits to domestic partners that are comparable to those provided to federally-recognized opposite sex spouses. Under the proposed regulations, death benefit protection for surviving spouses (as allowed under federal law) is more favorable than the protection afforded non-spouse designated beneficiaries (which would include same-sex domestic partners). This is one area where future guidance might recognize that inequality and find a way to equalize the benefits of QLAC options for surviving non-spouse designated beneficiaries.
- **After-tax Employee Contributions.** Much of the guidance involving defined contribution plans assumes that the plans in question do not offer after-tax employee contributions. For plans that permit after-tax employee contributions, the guidance creates more uncertainty and complexity in how the new rules would apply. For example, if a defined contribution plan wants to offer a rollover of amounts from a defined contribution plan to a defined benefit plan and the defined contribution plan allows for after-tax contributions, there are technical and complex issues that arise regarding the tax treatment of the defined benefit plan payments. This is even more complex when the rollover consists of only a part of the defined contribution plan account**.** Similar tax issues would apply to deferred annuity contracts as contemplated by Revenue Ruling 2012-3 and the QLAC proposed regulations.

- **Plan Termination Issues/M&A Considerations.** The new rules do not provide any guidance on what to do if a plan terminates and has these annuity options in the plan. For example, the QLAC proposed regulations indicate that QLACs cannot have a cash refund or similar feature. What would happen if a plan terminates at a time when a QLAC is held? Would the QLAC be distributed in kind? Would it be rolled over? What if an employer has a plan with QLACs and is acquired by another employer that does not want to offer QLACs? Similar issues would arise with any deferred annuity investment options made available. Employers will need to consider the contingencies before simply implementing these options.

- **Code Section 411(d)(6) Protection.** Under Code Section 411(d)(6), benefit distribution options in qualified retirement plans are subject to certain benefit protections that prevent modification or elimination with respect to benefits accrued to the date of amendment. It is not clear how deferred annuity products, defined contribution rollover options and QLACs will be analyzed under these benefit protection rules. The question arises where an employer starts to offer these options and then later decides to stop offering them. Will any of these rights be protected as to existing account balances? In many cases, it will depend on how the options are structured. However, sponsors need to consider these options carefully in light of the strict anti-cutback requirements under Code Section 411(d)(6).

- **Nondiscrimination Rules.** Qualified retirement plans are subject to nondiscrimination rules so that benefits do not disproportionately favor highly compensated employees. A nondiscrimination question could arise as to any limitations imposed on these new annuity options. For example, the IRS proposed QLAC regulations limit the amount of the account balance that can be used as a QLAC premium to the lesser of 25 percent of the account balance or $100,000**.** However, suppose an insurer determines to set a minimum premium amount for a QLAC of, say, $10,000. In that case, would a plan have to test the availability of the QLAC option to make sure that limiting it to account balances of $40,000 or more does not disproportionately benefit highly compensated employees? The guidance is not clear on this point.

- **Deferred Annuity Purchases and ESOPs.** In regard to the Spousal Consent Requirements, Revenue Ruling 2012-3 specifically states that the 401(k) plan in question did not have any portion of the plan qualify as an ESOP. Presumably, this condition was imposed because of the statutory exception from the Spousal Consent Requirements for ESOPs. Nevertheless, many large employer plans that maintain stock funds as investment options treat their stock funds as ESOPs. It is not clear how the new guidance would apply to these plans.

- **Fiduciary Concerns.** Of course, at this point, there are no clear rules on the fiduciary implications of offering deferred annuity options as investment options in defined contribution plans. Subject to future guidance in the area, it will be important for employers and fiduciaries to consider the fiduciary implications of offering annuity contracts as investment options.

  By way of background, under Section 404(c) of ERISA, if a plan provides for individual accounts and permits a participant to exercise control of the assets in his or her account, then the plan's fiduciaries will not be liable "for any loss, or by reason of any breach, which results from such participant's, or beneficiary's exercise of control." Section 404(c) is heavily relied upon by fiduciaries and is, essentially, a limitation of liability provision. In addition to other requirements, Section 404(c) requires that for every investment option allowed under the plan, the plan may impose only reasonable restrictions on the frequency with which participants and beneficiaries may give investment instruction.

For the defined contribution deferred annuity investments described in the guidance, a participant's ability to change the investment after the annuity option is selected is either severely limited or nonexistent. This raises the important question of whether the fiduciaries of a plan that offers deferred annuity investments are entitled to the protections of ERISA Section 404(c) with respect to those investments – in other words, is offering an annuity form of investment that may not be changed an unreasonable restriction on the frequency with which participants may give investment instruction? Future DOL guidance on this point would be welcome.

> **Administrative Issues.** In addition to the concerns mentioned above, a number of administrative issues come up that may make it difficult for plan sponsors to decide whether annuity options make sense. For example, permitting QLACs as a defined contribution investment could result in plans having to keep track of former participants and spouses for upwards of twenty years – long after the date those individuals take lump-sum distributions or rollovers from the plans. Locating these people and determining what to do with the benefits of missing participants could create significant problems for plan administrators. Another issue arises in the context of qualified domestic relation orders ("QDROs"). In general, a QDRO is a legal order issued in connection with a divorce that assigns some or all of a retirement plan participant's benefits to a spouse, former spouse, child or other dependent**.** QDROs generally provide the QDRO beneficiary with the same or similar rights of the participant. It is not clear how these new annuity-related options will affect QDRO administration. A third issue involves tracking employer QLAC premiums among all plans to comply with the $100,000 maximum premium limit.

Action Items

> Plan sponsors should review this new guidance carefully and consider their available options in light of their existing plan structure. Remember, the application of these rules depends very much on an employer's specific facts. Also, bear in mind that much of the guidance is proposed and employers should not make definitive changes before final regulations are issued.

> Employers and other interested parties should consider filing comments with the IRS and Treasury Department to the extent the ambiguities and uncertainties in the existing guidance impede the feasibility of implementing the options.

Please feel free to contact your regular Proskauer lawyer or any member of our Employee Benefits, Executive Compensation and ERISA Litigation Practice Center if you have any questions or need any assistance in evaluating this important new guidance. In addition, if you have any questions regarding the matters discussed in this report, please contact any of the lawyers listed below:

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