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PENSION ANALYST

Important information — Plan design



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IRS provides new options for providing lifetime income from defined contribution plan accounts

Who's affected

This guidance applies to sponsors of qualified defined contribution plans. It does not apply to governmental plans, church plans that do not elect to be covered by ERISA ("non-electing church plans"), or 403(b) plans.

Background and summary

On February 2, 2012, the IRS published several pieces of guidance to encourage defined contribution plan sponsors to offer lifetime income options. This package of guidance included two proposed regulations and two Revenue Rulings:

- [Revenue Ruling 2012-3](#) addresses the application of the qualified joint and survivor annuity (QJSA) rules to the purchase of deferred annuity contracts under a defined contribution plan. It illustrates how a plan that is not otherwise subject to the QJSA rules may offer annuities with less burdensome QJSA notice, waiver, and spousal consent rules.
- [Revenue Ruling 2012-4](#) provides a framework for employers that wish to allow participants to roll over defined contribution plan distributions to their defined benefit plan and receive an annuity from that plan. In doing so, it addresses concerns about the application of vesting rules and the maximum defined benefit limit to the additional benefit related to such a rollover.

Action and next steps

Plan sponsors that are interested in providing lifetime income options to participants in their defined contribution plans should read this publication carefully. Before implementing any changes to their plans, they should carefully explore available alternatives with their document providers and recordkeepers, including Prudential Retirement. Plan sponsors are not required to make these options available to their plan participants and may want to wait to take any action until the companion proposed regulations are finalized.

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Basic defined contribution plan QJSA rules

Money purchase pension plans, like defined benefit plans, are always subject to the QJSA and qualified preretirement survivor annuity (QPSA) rules. These rules require participant waivers and written, notarized spousal consent to a participant's election of any form of benefit other than the QJSA or Qualified Optional Survivor Annuity (QOSA) and to any waivers of QPSA death benefits.

However, profit sharing plans, including 401(k) plans, are not subject to the QJSA and QPSA rules if they meet the following three requirements:

- A participant's surviving spouse is the automatic beneficiary of 100% of the participant's vested account balance;
- The participant does not elect a life annuity form of payment; and
- The plan has not received a transfer of assets for the participant from a plan that was subject to the QJSA and QPSA rules.

To qualify for this "profit sharing exception" rule and avoid the additional administrative work required under the QJSA and QPSA rules, many plan sponsors have simply avoided offering any type of annuity payments from their plans. The new guidance provides plan design options for plan sponsors that want to offer lifetime income options without subjecting a plan to the burdensome QJSA and QPSA rules.

Offering deferred annuities

Revenue Ruling 2012-3 illustrates three different outcomes relating to QJSA and QPSA rules when a profit sharing plan offers a deferred annuity option. The essential element in all three situations is treating the deferred annuity as an investment option, rather than as a form of benefit payment.

In all three situations, a plan that otherwise satisfies the profit sharing exception requirements also allows participants to direct the investment of their plan assets into deferred annuity contracts issued by an insurance company. These contracts require payments to begin by the first day of the month following the later of the date the participant retires or reaches age 65, subject to the required minimum distribution rules. Under these contracts, the amount payable is fixed on the first day of the first period for which an amount is paid, and this date is considered the "annuity starting date."

QJSA rules apply to amounts invested in deferred annuities only if alternative form of payment is elected

In the first situation,

- The participant may transfer amounts invested in the contract to other investments at any time before the annuity starting date;
- The normal form of payment under the contract is a QJSA;
- During the 180-day period ending on the participant's annuity starting date, he may elect payment under various annuity forms or may elect a single sum distribution;
- The participant's spouse must provide notarized consent to an election of a non-QJSA or non-QOSA form of payment, in accordance with the QJSA rules.
- If the participant dies before his annuity starting date, his surviving spouse (or designated beneficiary, if he is not married) will receive a death benefit equal to 100% of his vested accrued benefit under the contract, which is payable as a life annuity unless the spouse elects to receive a single sum payment.
- The participant is not charged a fee for the death benefit coverage and cannot waive this coverage or name a non-spouse beneficiary if he is married.

As long as the plan separately accounts for the deferred annuity investments, the remainder of the participant's account balance is not subject to the QJSA and QPSA rules. Since the ultimate form of payment is not elected when amounts are invested in the deferred annuities, there is no need to comply with the QJSA rules at that time. Compliance with the QJSA rules is only required when distributions are made from the deferred annuity contracts if the participant elects a non-QJSA or non-QOSA form of payment.

QJSA rules apply to all distributions from deferred annuity contracts

The second situation described by the IRS is similar to the first, but contains some notable differences:

- The participant *may not transfer* amounts invested in the contract to any other investments;
- The normal form of payment under the contract is a *single life annuity, regardless of the participant's marital status*;
- During the 180-day period ending on the participant's annuity starting date, he may elect payment under various annuity forms *only* -- a single sum distribution is *not* a payment option;
- If the participant dies before his annuity starting date, his surviving spouse (or designated beneficiary, if he is not married) will receive a death benefit equal to 100% of his vested accrued benefit under the contract, which is payable as a life annuity unless the spouse elects to receive a single sum payment.
- The participant is not charged a fee for the death benefit coverage and cannot waive this coverage or name a non-spouse beneficiary if he is married.

As in the first situation, as long as the plan separately accounts for the deferred annuity investments, the remainder of the participant's account balance is not subject to the QJSA and QPSA rules. However, since the normal form of payment from the deferred annuity contracts is a single life annuity, regardless of the participant's marital status, distributions from those contracts are subject to the QJSA notice and consent rules. Since the annuity form of payment is "selected" when the first amounts are invested in the contracts, the QJSA rules are effective at that time.

QPSA waiver rules apply to investments in deferred annuity contracts

In the third situation,

- The participant may not transfer amounts invested in the contract to any other investments;
- The normal form of payment under the contract is a single life annuity, regardless of the participant's marital status;
- During the 180-day period ending on the participant's annuity starting date, he may elect payment under various annuity forms *only* -- a single sum distribution is *not* a payment option;
- If the participant dies before his annuity starting date, his surviving spouse (or designated beneficiary, if he is not married) will receive a death benefit equal to 100% of his vested accrued benefit under the contract, which is payable as a life annuity unless the spouse elects to receive a single sum payment.
- The participant is not charged a fee for the death benefit coverage but he *may elect to have no pre-retirement death benefits payable under the contract from amounts attributable to his matching contributions*. His spouse's written, notarized consent to such an election is required.

As was the case in the second situation, amounts invested in these deferred annuity contracts become subject to the QJSA rules when the initial investments are made in the contracts and appropriate notices and spousal consent must be obtained at distribution. In addition, the plan must provide QPSA notices and obtain spousal consent to any death benefit waivers. As long as the plan separately accounts for the deferred annuity investments, the remainder of the participant's account balance is not subject to the QJSA and QPSA rules.

Rollover to a defined benefit plan to purchase an annuity

In Revenue Ruling 2012-4, the IRS confirms that participants may roll over distributions from a profit sharing plan that satisfies the profit sharing exception rule to a defined benefit plan, in order to obtain an annuity form of payment. It also provides guidelines to ensure that the conversion of the lump sum rollover amount to annuity does not violate vesting or benefit limitation rules.

Basic plan design

In the situation presented by the IRS, an employer sponsors two plans, a profit sharing plan and a defined benefit plan.

The profit sharing plan does not accept employee after-tax contributions. It is not clear if it contains a 401(k) feature; however, the IRS typically considers 401(k) deferrals to be employer contributions. The plan does satisfy the profit sharing exception rule and is not subject to the QJSA and QPSA notice and consent rules.

The defined benefit plan is funded solely by employer contributions. It allows benefit payments to begin any time after separation from service and offers various optional forms of benefit. Benefit payments may begin between 30 and 180 days

after the QJSA notice is provided. Participants may not elect a retroactive annuity starting date. The only pre-retirement death benefit payable under the plan is the QPSA. As a result, no death benefit is payable if an unmarried participant dies before his retirement date.

The defined benefit plan will accept a direct rollover from the profit sharing plan for any employee or former employee who separates from service after reaching age 55 and completing at least 10 years of service. However, the individual must also elect to begin receiving benefits from the defined benefit plan and specify a single annuity starting date for all of his benefits, including the amounts rolled over from the profit sharing plan. The amount directly rolled over must be used to provide an immediate annuity that is the actuarial equivalent of the rollover amount. If the participant dies before his annuity starting date, a death benefit equal to the amount rolled over, plus interest, is payable to his beneficiary. If the participant is married at the time of death and did not waive the QPSA, this additional death benefit is paid to his surviving spouse as a life annuity.

Specific requirements for conversion to an annuity

Under this type of design, the defined benefit plan must determine the actuarial equivalence of the amount rolled over using the applicable section 417(e) interest rate and mortality table. If there is a delay between the date of rollover and the participant's annuity starting date, interest must be credited in accordance with the interest crediting rules applicable to required employee contributions under defined benefit plans. If these requirements are met, the benefit resulting from the rollover does not count towards the maximum annual defined benefit limit.

While a plan cannot use a less favorable actuarial basis to determine the additional annuity resulting from the rollover, it can use a more favorable basis. If a more favorable basis is used, resulting in a larger annuity, the amount of the annuity that exceeds the amount determined using applicable interest and mortality would be counted towards the maximum annual defined benefit limit.

Effective date of these rules

The holdings in Revenue Ruling 2012-4 apply to rollovers made on and after January 1, 2013. However, plan sponsors may follow these rules for rollovers made prior to that date.

Implications for plan design

While this guidance is helpful, plan sponsors should study their current plan designs before attempting to make changes to either incorporate deferred annuity options under defined contribution plans or encourage direct rollovers from defined contribution plans to defined benefit plans to obtain annuity forms of payment.

From a practical standpoint, plan amendments will likely be needed in order to reflect either of these design options. To the extent that a plan sponsor uses pre-approved documents, these amendments may not be readily available. Participant communications, such as a Summary of Material Modifications (SMMs) will also be needed.

If a plan sponsor wants to add a deferred annuity investment option to its defined contribution plan, it will need to locate a provider and will have to work with that provider to determine how to reflect that new investment on participant benefit statements.

Special QJSA and QPSA notices may also be needed, along with modified benefit distribution packages.

Plan sponsors that are interested in pursuing either of these design options should contact their Prudential Retirement representative for additional assistance before implementation to ensure that the proposed design is compatible with our recordkeeping capabilities.

Pension Analyst by Prudential Retirement

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