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PENSION ANALYST

Important information—Plan administration and operation



Prudential
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IRS and DOL issue guidance on target date funds

Who's affected

This guidance affects plan sponsors of and participants in defined contribution plans, including 401(k) plans, ERISA 403(b) plans, and multiemployer plans. These rules do not apply to defined benefit plans, governmental plans, non-electing church plans, or non-ERISA 403(b) arrangements.

Background and summary

Target date funds (TDFs) have become a popular investment option in 401(k) plans and other participant-directed retirement plans. They are attractive investment options for employees who do not want to actively manage their retirement accounts. TDFs offer a long-term investment strategy based on a mix of stocks, bonds and other investments. TDFs automatically rebalance to become more conservative as an employee nears retirement by lessening equity exposure and increasing exposure in fixed income type investments. Principal value is not guaranteed, including at the target date. The "target date" refers to the target retirement date.

Many plan sponsors use TDFs as their plan's [qualified default investment alternative \(QDIA\)](#). A QDIA is a default investment option chosen by the plan fiduciary for participants who fail to make an election regarding the investment of their account balances.

Recently the Internal Revenue Service (IRS) issued guidance that enables qualified defined contribution plans to provide lifetime income by offering, as investment options, a series of TDFs that include deferred annuities among their assets, even if some of the TDFs within the series are available only to older participants. This guidance in IRS [Notice 2014-66](#) (Notice) provides that if certain conditions are satisfied, a series of TDFs in a defined contribution plan will be treated as a single right or feature under the Internal Revenue Code (IRC) nondiscrimination rules.

In addition, the Department of Labor (DOL) sent a [letter](#) to the IRS confirming that TDFs serving as QDIAs may include annuities among their fixed income investments. The letter also reinforces the applicability of the annuity selection safe harbor and further describes how fiduciary requirements can be satisfied when a plan sponsor appoints an investment manager that selects the annuity contracts and annuity provider.

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 their options with their document providers and recordkeepers, including Prudential Retirement. As an alternative, they may want to consider other solutions designed to provide guaranteed income or the options made available under [IRS Revenue Rulings 2012-3 and 2012-4](#).

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Nondiscrimination requirements

The Internal Revenue Code provides that a qualified plan cannot discriminate in favor of highly compensated employees. The nondiscrimination rules require optional forms of benefit, ancillary benefits and other rights and features must be available in a nondiscriminatory manner.

The term “other right or feature” generally means any right or feature applicable to employees under the plan. Different rights or features exist if a right or feature is not available on substantially the same terms as another right or feature. The right to a particular form of investment is considered an “other right or feature.”

For an arrangement that includes a series of TDFs, some of which hold deferred annuities, questions have arisen regarding compliance with these nondiscrimination requirements.

Notice 2014-66

IRS Notice 2014-66 describes an arrangement under which a plan’s investment options include a series of TDFs, some of which hold deferred annuities. Under the arrangement, the TDF series is a group of TDFs managed by an investment manager and each of the TDFs is invested in a manner appropriate for a particular age group, with a mix of equity and fixed income exposure becoming more conservative over time in order to reflect the applicable age group’s advancing age. Each Fund within the series is available only to participants who will attain normal retirement age within a limited number of years around the Fund’s target date. Each Fund available to participants age 55 or older holds unallocated deferred annuity contracts, which constitute a portion of the Fund’s fixed income investments. Funds available to participants younger than 55 do not include unallocated deferred annuity contracts. However, the series is designed so that as the asset allocation changes over time, each TDF will include unallocated deferred annuity contracts beginning when participants in that Fund attain age 55.

As each group’s age advances, an increasing portion of the portfolio is applied to purchase unallocated deferred annuity contracts. At its target date, each Fund dissolves and participants with an interest in the Fund receive an annuity certificate providing for immediate or deferred annuity payments. The certificate represents the participant’s interest in the unallocated deferred annuity contract held by the Fund.

If the deferred annuity is made available only to older participants, these participants could disproportionately consist of highly compensated employees since as a group, older employees are often paid more than younger employees. The concern is that this arrangement could violate the nondiscrimination rules.

Treatment of a series of TDFs as a single right or feature

IRS Notice 2014-66 confirms that the right to each form of investment, including each TDF in a series of TDFs, is an “other right or feature” and each TDF must be made available in a nondiscriminatory manner. However, the IRS has provided an alternative method for satisfying the nondiscrimination requirements when some of the TDFs are restricted to participants in particular age-bands. The IRS has determined that this arrangement is permitted to be treated as a single “other right or feature” provided the following conditions are satisfied:

- The series of TDFs is designed to serve as a single integrated investment program with the same investment manager who manages each TDF and applies the same investment theories across the series of TDFs. The only

difference among the TDFs is the mix of assets selected by the investment manager, which results from the intent to achieve the level of risk appropriate for the age-band of individuals participating in each TDF.

- Some of the TDFs available to participants in older-age bands include deferred annuities and none of the annuities provide a guaranteed lifetime withdrawal benefit (GLWB) or guaranteed minimum withdrawal benefit (GMWB).
- The TDFs do not hold employer securities that are not readily tradable on an established securities market.
- Each TDF in the series is treated in the same manner with respect to rights or features other than the mix of assets. For example, fees and administrative expenses for each TDF are determined in a consistent manner and the extent to which those fees and expenses are paid from the assets (rather than by the employer) is the same.

Future IRS guidance

Under a contract that provides GLWBs, the participant is guaranteed to receive a specified stream of lifetime income regardless of the investment performance of his account, while retaining access to the funds in the account. A GMWB feature is similar to a GLWB feature but a stream of income is guaranteed for a specified period rather than for the lifetime of the annuitant.

The IRS is considering whether to provide guidance related to issues arising from the use of GLWB and GMWB features in defined contribution plans. Prudential Retirement will keep plan sponsors informed if the IRS issues guidance.

DOL guidance

Concurrently, the Department of Labor issued an information letter to the IRS clarifying that a series of TDFs may serve as a QDIA for those participants who do not provide investment direction for their accounts. The letter also provides guidance regarding the selection of annuity contracts by a designated investment manager.

QDIA guidance

The QDIA rules require, among other things that participants:

- Had the opportunity to direct the investment of the assets in their account but did not; and
- Are provided with a notice describing:
 - The circumstances under which their assets may be invested in the QDIA;
 - Their right to direct the investment of their assets into any plan investment alternatives; and
 - The investment objectives, risk, and return characteristics, fees and expenses associated with the QDIA.

It is important to note that in the DOL's view, the use of unallocated deferred annuity contracts would not cause the Funds to fail to meet the QDIA requirements and the inclusion of a lifetime income guarantee does not automatically disqualify a TDF as a QDIA.

Annuity selection safe harbor

The annuity selection safe harbor requirements for defined contribution plans are satisfied if the plan's fiduciary:

- Engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;
- Appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;
- Appropriately considers the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract;
- Appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract; and

- If necessary, consults with the appropriate expert or experts for purposes of compliance with these provisions.

The DOL specifically refers to the [existing annuity selection safe harbor](#) for combining lifetime income guarantees with TDFs. In the arrangement described in IRS Notice 2014-66, the plan sponsor, acting as the plan's fiduciary, designated an investment manager to manage the investment of each Fund, including the selection of the provider and the unallocated deferred annuity contracts. The selection of the provider and the unallocated deferred annuity contracts is a fiduciary decision.

The DOL concluded that the selection of the provider and the unallocated deferred annuity contract will satisfy the annuity selection safe harbor requirements if a designated investment manager satisfies each of the conditions of the annuity selection safe harbor. However, the DOL emphasizes that the plan sponsor, as fiduciary, has the duty to prudently select the investment manager and appropriately monitor the selection at reasonable intervals to assure the prudence of maintaining the appointment.

After the investment manager is appointed, the investment manager is responsible for the prudent management of the plan's assets and selection of the unallocated deferred annuity contracts. The plan sponsor will not be liable for any acts or omissions of the investment manager, except for any potential co-fiduciary liability, provided the plan sponsor appropriately discharged its duties as the appointing fiduciary.

Plan sponsor next steps

Plan sponsors are not required to offer a target date fund series that limits different participants to different funds and also only includes deferred annuities in some funds. Plan sponsors that are interested in providing lifetime income options to participants in their defined contribution plans may want to consider other options that are available. Before making any changes to their plans, they should carefully explore these options with both their document providers and recordkeepers, including Prudential Retirement, to ensure compatibility between plan design and administrative capabilities.

Pension Analyst by Prudential Retirement

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