"In-Plan" Deferred Fixed Annuities: What you should know & ask

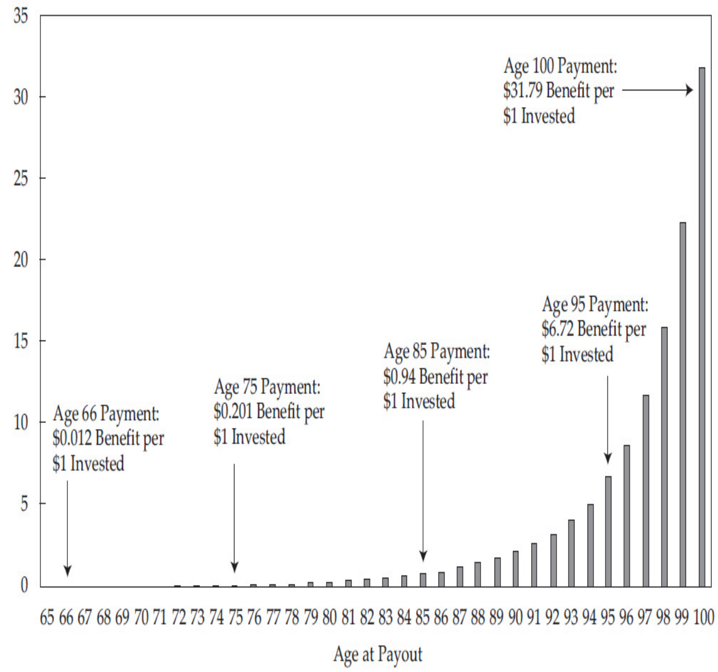
In 2014, the IRS issued two (2) directives (the first a "Final Regulation," the second a "Notice") regarding deferred fixed annuities to be used in ERISA Defined Contribution plans. [In both cases, "variable" annuities were excluded with a footnote in the latter directive being that they would be considered for future inclusion as a component of Target Date Funds (TDF's)]. These have received much (well-deserved) discussion in various trade publications. The purpose of this thought piece is to share our perspective on some of the questions that Plan Sponsors might want to consider as they review these developments. And the first thought that we would share is: the IRS has visited this subject before.

In 2012, the IRS addressed the question of how the Qualified Joint and Survivor Annuity (QJSA) and Qualified Preretirement Survivor Annuity (QPSA) rules apply when a deferred annuity is purchased by a Participant in a "profit sharing" plan with a Cash Or Deferred Arrangement (CODA). (See Rev. Rul. 2012-3).

In that Rev. Rul., the IRS posited three different hypotheticals involving plan designs which: 1) allowed Participants to move in and out of the deferred annuity at any time before the annuity starting date, 2) made the purchase of the deferred annuity irrevocable payable in the form of a life annuity without an option for the participant to accelerate payment of the amounts in the form of a single-sum payment, and 3) allowed "matching contributions" to be returned to the trust in the event of death before the annuity start date subject to a spouse's notarized consent. (As we noted in a previous thought piece on this subject, several insurers were working on products for this market before the market crash of 2008).

We would suggest that the significance of this earlier Rev. Rul. is that when read with the latter two issuances, it appears that the IRS is acknowledging (encouraging?) a very wide range of plan designs using deferred annuities. And, we think that is a very good thing because it means that the various "products" that are beginning to appear will not be the "only" way to skin-the-cat.

We are very strong advocates of deferred-fixed-annuities and their use in qualified retirement plans. In our judgment, a particularly useful article on their benefits is: <u>The Longevity Annuity: An Annuity For Everyone</u>?, Jason S. Scott, Financial Analysts Journal, Vol. 64, Number 1 (2008). The graph below is taken from that article and is a good aid to help visualize their increasing value as annuitization is delayed.



Now, we will briefly summarize the more recent IRS issuances.

In July 2014, the IRS issued (with the DOL) a joint Final Regulation articulating a Qualified Longevity Annuity Contract (QLAC). That Regulation focused on the idea of an "individual" buying a deferred fixed annuity ("in" a retirement plan) which would begin paying out at some point "after" Required Minimum Distributions (RMD's) would otherwise be required to begin. The Regulation discussed hypothetical beginning start dates of age 80 or 85 as examples. But no specific annuitization "starting date" was prescribed. But the net effect is to delay - but not avoid altogether - RMD's

The "Notice" (October 2014) on the other hand, focused on a scenario in which a deferred fixed annuity would be used in a TDF - which, in turn, could be used as a QDIA and/or as a stand investment offering. The "technical" issue was whether the TDF could be structured so as to only make the deferred fixed annuity available in a *near-retirement* sleeve of the TDF (ex: 50-55 year old) which, in turn, might foreseeably result in it being used by predominately highly compensated employees. The concern was/is, this could possibly/likely cause the plan's year-end non-discrimination testing to fail. So, the Notice (supported by an interpretative letter from the DOL) essentially created a safeharbor from this possibility.

Issues

1) Fiduciary Duties - and whose are they?

The general rule is that the Plan Sponsor is responsible for the selection of a deferred annuity issuer. Moreover, the historical rule (developed in the context of buying-out a defined benefit obligation) was "safest available annuity." See DOL IB 95-1. The Pension Protection Act modified that in the context of Defined Contribution plans to be a five (5) step process designed to demonstrate that the choice was undertaken objectively and was reasonable. See DOL IB 95-1 (As Amended Dec. 8, 2008). Importantly, in its October Notice, the IRS shifted the fiduciary duty for the selection of the annuity (when used in a TDF) from the Plan Sponsor to the ERISA Investment Manager who was otherwise responsible for the creation and monitoring of the TDF.

2) Is there only one type of deferred annuity?

No. A deferred annuity can either be fixed or variable; an individual or group contract; or a single or blended premium. The 2012 Rev. Rul. didn't speak to any of that. But, the more recent Final Regulation and Notice did. A QLAC can only be a deferred-fixed-annuity. For now (but it indicated that it would address this distinction prospectively) the annuity authorized for use in a TDF is also a deferred-fixed-annuity. Our own perspective is that deferred fixed annuities are preferable to deferred variable annuities. In short, we think this subject - which under either version can be plenty complicated - should be kept as simple as possible. But, we also recognize that there are many in our industry who feel the opposite.

3) What are "riders" - and what are their impact?

One of the primary impacts of focusing on the individual as a potential buyer is the corresponding need to provide a liquidation "rider." To illustrate, the TDF as described in the Notice would allow the Participant to get in and out of the position just like s/he would any other investment. But, that liquidity will come at a cost - opaque at best. While not as frequent, the same will be true if the Plan Sponsor decides to move from one recordkeeper to another. Again, the IRS's 2012 Rev. Rul. Arguably provides the answer in its Hypothetical #3 which did not allow a liquidation feature.

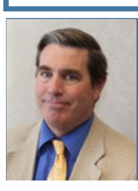
4) ***Can a Plan Sponsor purchase deferred annuities on behalf of Plan Participants - and, if so, can it buy them in increments or must it be a lump sum?***

None of the IRS issuances directly addressed these interrelated questions. But, we think that "yes" to these questions can be inferred. That is, its TDF Notice specifically noted that the TDF (with the annuity feature) could be used as a QDIA. And - by definition - the whole point of the QDIA was to give Plan Sponsors safeharbor from what would otherwise be fiduciary liability for making an investment decision (e.g. the QDIA itself) "for" the participant in the absence of its affirmative election - and, by definition, meant that there would incremental purchases. Finally, QDIA's are not limited to Plan Participant "elective deferrals" but can also be used for Plan Sponsor contributions.

Frankly, we think that this is a critical question because we also think that the solution to the admirable goal of guaranteed lifetime income can be over-engineered. In other words, why not simply set up a parallel plan (like the Money Purchase Pension Plan of yesteryear) and use *only* Employer monies to buy deferred fixed annuities for all participants, at all ages and with incremental (ex: year-end discretionary profit sharing) contributions? Among the many problems this solves is "daily valuation." With the simple/stupid approach, each participant could be given an annual statement. And, if a "group" contract is used it may be possible to use a "uni-sex" life expectancy table which would result in higher payouts to some Plan Participants.

5) How do I know that the chosen insurer will continue to provide a competitive crediting rate after year #1?

This is the toughest and most critical question of all - and none of the IRS's issuances addressed it. When we began thinking about this subject years ago, we thought that it might be possible to issue an RFP requiring the responding insurers to specify (year-over-year) a floating crediting rate (set, hypothetically, Jan. 1 and applied to all contributions through 12/31) to the 10 year treasury curve - reset at the end of each year and applied for the next 12 months. For example, one carrier might say the 10 year rate less 30 bps and another might say the 10 year rate less 20 bps. After all, we thought, a number of insurance-company Guaranteed Investment Contracts (GIC's) already do some version of this. Another possible solution would be to have the insurer commit to using a pre-agreed-upon pricing metric such as Blackrock's CoRI annuity pricing model. But the bottom line is this: we think some sort of forward-pricing agreement is essential..



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