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IRS AND DOL ENCOURAGE DC PLAN PARTICIPANTS TO HEDGE BETS AGAINST OUTLIVING RETIREMENT SAVINGS

Nov 05, 2014

On October 24th, the Internal Revenue Service (“IRS”) and the Department of Labor (“DOL”) offered guidance on the use of a series of target date funds (“TDFs”) in defined contribution plans that would include investment in deferred annuities in the TDFs for older participants. As baby boomers get older and life expectancies continue to increase, this arrangement has been touted as a way for defined contribution plan participants to invest a portion of their accounts in lifetime income in order to protect themselves from outliving their retirement savings. Many plan sponsors and advisors have hesitated to jump on this band wagon preferring to await guidance on a number of issues that arise from the arrangement.

In Notice 2014-66, the IRS offers some clarity regarding nondiscrimination issues. Guidance had been requested because, for actuarial reasons, the TDFs for the older age groups would only be open to participants within the target age range. Because older participants tend to be more highly compensated, there was a concern that this arrangement would violate section 401(a)(4) of the Internal Revenue Code (the “Code”) which prohibits discrimination in favor of highly compensated employees. Under Code section 401(a)(4) and applicable regulations, each investment option is a right or feature that must be made available in a nondiscriminatory manner that does not violate the applicable current availability or effective availability requirements.

In response to this concern, the IRS provides a special rule that enables 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. Under this special rule, if certain conditions are satisfied, a series of TDFs will be treated as a single right or feature for purposes of the nondiscrimination requirements of 401(a)(4) so that the requirements applicable to rights or features will be satisfied even if one or more of the TDFs, considered on its own, would not satisfy the requirements.

In the notice, the IRS outlines four conditions that must be satisfied in order to take advantage of this alternative means for complying with the nondiscrimination requirements:

- the TDFs must be part of a single integrated investment program under which the same investment manager manages each TDF and applies the same generally accepted investment theories and strategies across the series so that the only difference among the TDFs is the mix of assets selected to achieve the appropriate level of risk for the particular age group;
- none of the deferred annuities may provide a guaranteed lifetime withdrawal benefit or a guaranteed minimum withdrawal benefit;
- the TDFs must not hold employer securities that are not readily tradable on an established securities market; and
- each TDF in the series must be treated in the same manner with respect to rights or features other than the mix of assets. For example, the fees and administrative expenses for each TDF must be determined in a consistent manner and the extent to which the fees and expenses are paid from plan assets must be the same.

On the same day, the DOL released a letter to the Treasury Department offering guidance regarding fiduciary issues related to this arrangement. The letter provides that the use of unallocated deferred annuity contracts in TDFs would not cause the funds to fail to satisfy the QDIA requirements under the regulations as long as the investment manager satisfies each of the conditions of the annuity selection safe harbor. In addition, the letter clarifies that if a plan sponsor prudently selects and monitors the investment manager, the investment manager will be responsible for selecting the annuity provider and the unallocated deferred annuity contracts. The plan sponsor will not be liable for the acts or omissions of the investment manager except for any potential co-fiduciary liability under section 405(a) of ERISA.

This guidance certainly provides some clarity and comfort for defined contribution plan sponsors who may be interested in allowing participants the opportunity to invest in deferred annuities. In addition, it seems certain that annuity providers will be encouraged. Still, it is too early to tell how commonplace this investment option will become and the extent to which it will be embraced by participants.

MEET THE TEAM

Denise Pino Erwin

Denver

denise.erwin@bclplaw.com

+1 303 866 0631

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