

## employee benefits lawflash

November 19, 2014

## IRS and DOL Issue Guidance on Including Deferred Annuities in Target Date Funds

*Guidance addresses nondiscrimination, qualified default investment alternative, and annuity safe harbor rules.*

On October 24, the Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL) each issued guidance on defined contribution plans offering target date funds (TDFs) that include deferred annuities as a part of the TDFs' allocation to fixed income investments. The IRS published IRS Notice 2014-66 (Notice),<sup>1</sup> which outlines the circumstances under which TDFs can restrict participation in each TDF in the series to designated age-bands in order to invest in deferred annuities without violating Internal Revenue Code (the Code) nondiscrimination rules. The DOL issued a related information letter (DOL Information Letter), addressed to J. Mark Iwry, a Senior Advisor at the Department of the Treasury,<sup>2</sup> to clarify how such arrangements can obtain the safe harbor protection afforded to qualified default investment alternatives (QDIAs) and the selection of annuities. Together, these two pieces of guidance make it clear that plans can offer, as both default and participant-elected investment options, TDFs that distribute annuities. Both sets of guidance are part of broader IRS and DOL initiatives to support the offering of lifetime income features in defined contribution plans to retirees.

### Background

The Notice and the DOL Information Letter both address the offering of TDFs investment options in defined contribution plans when the TDFs include among their assets deferred annuities. In the facts set forth in this guidance, a single investment manager oversees a series of TDFs and manages each individual TDF in the series in a manner appropriate for the designated age group. In order to provide income over the lifetime of the retiree, the TDF is designed to increasingly invest in deferred annuities as the TDF reaches its target retirement date and investors in the TDF get older. When the TDF reaches its target date, annuity certificates are then distributed to participants and begin payment at retirement. The IRS noted that these structures require age-based restrictions because insurers necessarily price the annuities based on the age of the investing plan participants.

The Notice answers the question of whether these arrangements violate the nondiscrimination rules under Code section 401(a)(4) in instances where the age-based restrictions cause certain TDFs in the series to have a greater concentration of highly compensated participant investors. In particular, the Notice evaluates whether such age-restricted TDFs violate the Code's requirement that any "other right or feature" under a plan—interpreted to include the right to a particular form of investment—be "currently" and "effectively" available to non-highly compensated participants on a nondiscriminatory basis.

The DOL Information Letter analyzes two related questions. First, the DOL explores whether such arrangements can serve as QDIAs. Under applicable DOL regulations,<sup>3</sup> a fiduciary to an individual account defined contribution

1. View IRS Notice 2014-66 at <http://www.irs.gov/pub/irs-drop/n-14-66.pdf>.

2. View the letter to J. Mark Iwry at the Department of Treasury from Phyllis C. Borzi, Assistant Secretary, DOL, at <http://www.dol.gov/ebsa/regs/ILs/il102314.html>.

3. 29 C.F.R. § 2550.404c-5.

plan can enjoy protection from liability when a participant or beneficiary fails to make an investment selection and their plan assets are invested on a “default” basis into a QDIA when the conditions of the DOL’s QDIA safe harbor are met. The DOL Information Letter provides guidance on whether a TDF that invests in annuities (as described in the Notice) can be treated as a TDF QDIA. Second, the DOL analyzes whether the DOL’s existing annuity selection safe harbor rule<sup>4</sup> covers a plan fiduciary’s decision to select the deferred annuities described in the Notice. Under the annuity selection safe harbor, plan fiduciaries can be protected from fiduciary liability when the conditions of the safe harbor are met.

## New Guidance

The Notice concludes that a defined contribution plan that offers a TDF arrangement that includes deferred annuities will not violate the Code’s nondiscrimination rules even if the individual TDF within the series has age-based restrictions, as long as the TDFs satisfy specified conditions. In particular, the IRS confirms that a TDF series that satisfies certain conditions may be treated as a single “other right or feature” for purposes of the nondiscrimination rules, so that separate testing of TDFs in the series that would have a greater concentration of highly compensated employees is not required. The requirements are as follows:

- First, the series of TDFs must be designed to serve as a “single integrated investment program” under a plan in which the same investment manager manages each TDF using a consistent investment strategy across the entire series (the only difference being the mix of assets based on the target date). The Notice gives as an example institutional TDFs that are established as “plan asset” funds and managed by an ERISA section 3(38) investment manager.
- Second, the TDFs available to participants in older age bands must include deferred annuities, which would be distributed to the investing participants when the TDF is dissolved upon reaching its target date.
- Third, the TDFs may not hold employer securities (other than employer securities that are readily tradable on an established securities market).
- Fourth, each TDF in the series must be treated in the same manner with respect to rights and features other than the mix of assets, such as with regard to fees and administrative expenses and whether those fees and expenses are paid from plan assets.

The Notice only describes the use of deferred annuities: it does not include TDFs that use annuities providing guaranteed lifetime withdrawal benefits or guaranteed minimum withdrawal benefits.

The Notice then provides an example of a TDF series eligible for relief, including from the Code’s nondiscrimination requirements. Among other facts, the example TDF series is offered as a designated investment option and as a QDIA in a qualified participant-directed 401(k) profit-sharing plan. Each TDF in the series invests in a mix of equities and fixed-income. An ERISA section 3(38) investment manager manages all of the TDFs in the series using a consistent strategy that is designed to become more conservative over time, including by investing in less equities and more fixed-income. Certain TDFs are available only to participants age 55 and over. Those age-restricted TDFs hold unallocated deferred annuity contracts purchased from an insurance company that is independent from the investment manager. At the same time, TDFs for participants under age 55 are designed to begin holding similar unallocated deferred annuity contracts when the fund’s participants reach age 55. All of the TDFs in the series dissolve at the specified target date. At that time, participants in the TDF receive a certificate for an immediate or deferred annuity payment, and the remaining portion of their investments is reinvested in other plan investment options. In addition, the investment manager and plan sponsor apply the same rights and features to each TDF in the series, including fees, administrative expenses, and the percentage of fees paid from plan assets.

The DOL Information Letter provides complementary guidance. First, the letter concludes that the TDFs described in the Notice can be QDIA TDFs, even though they include annuity contracts. In the DOL’s view, such arrangements can serve as QDIAs so long as the TDFs meet all other QDIA TDF requirements (such as providing

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4. 29 C.F.R. § 2550.404a-4.

proper notice and a right for participants to direct the investments out of the QDIA and meeting investment risk, return characteristic, and cost requirements). Second, the letter concludes that the annuities used in the TDFs described in the Notice can fall within the annuity selection safe harbor, again so long as the annuities otherwise meet all other conditions of that safe harbor. The DOL Information Letter also notes that the plan fiduciary selecting the TDF series need not be the fiduciary responsible for complying with the annuity selection safe harbor. In that case, the plan fiduciary's duties would be limited to prudently selecting and monitoring the TDF manager (unless co-fiduciary liability is triggered). (Under the example contemplated in the Notice, the TDF manager is responsible for the selection of the annuity contracts and thus for satisfying the requirements of the safe harbor.)

## Observations

These two pieces of guidance are part of a broader effort by the IRS and DOL to encourage defined contribution plans to offer lifetime income benefits to help retirees secure a reliable stream of lifetime retirement income. The IRS and DOL have previously expressed concern that retirees are increasingly bearing risks related to their retirement income, as retirement plans shift away from traditional defined benefit pension plans to support defined contribution plans. For example, the DOL recently stated a concern that with this continuing trend toward defined contribution plans, "employees are not only increasingly responsible for the adequacy of their savings at the time of retirement, but also for ensuring that their savings last throughout their retirement years and, in many cases, the remaining lifetimes of their spouses and dependents."<sup>5</sup> This shift toward retiree responsibility over post-retirement income is attributable to both the nature of defined contribution plans and that such plans often do not provide annuities and, instead, offer lump-sum distributions or "cash outs" as the most common form of distribution option. When a participant receives a lump-sum cash out, the participant must manage the investment of these assets over time so the participant does not outlive his or her investments.

In light of these risks, the IRS and DOL are looking to support solutions to offer retirement income over a retiree's lifetime. To that end, in 2010, the DOL and the IRS issued a Request for Information regarding lifetime income distribution arrangements.<sup>6</sup> As part of that effort, in May 2013, the DOL proposed rulemaking focusing on lifetime income illustrations in participant statements.<sup>7</sup> In July 2014, the IRS issued final rules regulating the inclusion in 401(k) plans and individual retirement accounts of qualified longevity annuity contracts, which are deferred income annuities that begin payment at an advanced age (as late as age 85).<sup>8</sup> The Notice and the DOL Information Letter fit within this larger lifetime income project by providing guidance aimed at enabling the use of income annuities in 401(k) plans that can provide lifetime retirement income.

The guidance should provide comfort for the use of deferred annuities in TDFs. It is also helpful to consider that the Notice provides guidance by way of example, leaving room for interpretation for variations in different target date fund annuity structures and for future innovations, so long as the general conditions described in the Notice are met. Similarly, the DOL Information Letter does not prescribe a specific type of investment structure, but clarifies the availability of the DOL QDIA and annuity selection safe harbors in these circumstances. Although in our experience, the usage of the DOL's annuity selection safe harbor has been more limited due to subjective conditions of the safe harbor (such as to "appropriately consider" the cost of the contract and to take steps "calculated to obtain the safest annuity available"), plan sponsors of defined contribution plans are not required to use the safe harbor and instead have flexibility to rely on third-party advisors or the doctrine of procedural prudence generally.

Although the Notice expressly does not apply to guaranteed minimum withdrawal benefits or guaranteed lifetime withdrawal benefits, in a footnote included in the Notice, the IRS indicated that it is considering issuing additional guidance on those structures, and so we are tracking this important issue for further regulatory developments.

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5. Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 75 Fed. Reg. 5,253, 5,254 (Feb. 2, 2010).

6. *Id.*

7. Advanced Notice of Proposed Rulemaking, Pension Benefit Statements, 78 Fed. Reg. 26,727 (May 8, 2013).

8. Final Regulations, Longevity Annuity Contracts, 79 Fed. Reg. 37,633 (July 2, 2014).

# Morgan Lewis

## Contacts

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis lawyers:

### Chicago

Brian D. Hector	+1.312.324.1160	<a href="mailto:bhector@morganlewis.com">bhector@morganlewis.com</a>
Louis L. Joseph	+1.312.324.1726	<a href="mailto:louis.joseph@morganlewis.com">louis.joseph@morganlewis.com</a>
Marla J. Kreindler	+1.312.324.1114	<a href="mailto:mkreindler@morganlewis.com">mkreindler@morganlewis.com</a>
Julie K. Stapel	+1.312.324.1113	<a href="mailto:jstapel@morganlewis.com">jstapel@morganlewis.com</a>

### New York

Craig A. Bitman	+1.212.309.7190	<a href="mailto:cbitman@morganlewis.com">cbitman@morganlewis.com</a>
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### Philadelphia

Robert L. Abramowitz	+1.215.963.4811	<a href="mailto:r Abramowitz@morganlewis.com">rabramowitz@morganlewis.com</a>
Brian J. Dougherty	+1.215.963.4812	<a href="mailto:bdougherty@morganlewis.com">bdougherty@morganlewis.com</a>
Amy Pocino Kelly	+1.215.963.5042	<a href="mailto:akelly@morganlewis.com">akelly@morganlewis.com</a>
Robert J. Lichtenstein	+1.215.963.5726	<a href="mailto:rlichtenstein@morganlewis.com">rlichtenstein@morganlewis.com</a>
Vivian S. McCardell	+1.215.963.5810	<a href="mailto:vmccardell@morganlewis.com">vmccardell@morganlewis.com</a>
Mark J. Simons	+1.215.963.5992	<a href="mailto:msimons@morganlewis.com">msimons@morganlewis.com</a>
Steven D. Spencer	+1.215.963.5714	<a href="mailto:sspencer@morganlewis.com">sspencer@morganlewis.com</a>

### Pittsburgh

Lisa H. Barton	+1.412.560.3375	<a href="mailto:lbarton@morganlewis.com">lbarton@morganlewis.com</a>
Elizabeth S. Goldberg	+1.412.560.7428	<a href="mailto:egoldberg@morganlewis.com">egoldberg@morganlewis.com</a>
John G. Ferreira	+1.412.560.3350	<a href="mailto:jferreira@morganlewis.com">jferreira@morganlewis.com</a>
R. Randall Tracht	+1.412.560.3352	<a href="mailto:rtracht@morganlewis.com">rtracht@morganlewis.com</a>

### Washington, D.C.

Althea R. Day	+1.202.739.5366	<a href="mailto:aday@morganlewis.com">aday@morganlewis.com</a>
Daniel R. Kleinman	+1.202.739.5143	<a href="mailto:dkleinman@morganlewis.com">dkleinman@morganlewis.com</a>
Gregory L. Needles	+1.202.739.5448	<a href="mailto:gneedles@morganlewis.com">gneedles@morganlewis.com</a>
Michael B. Richman	+1.202.739.5036	<a href="mailto:mrichman@morganlewis.com">mrichman@morganlewis.com</a>

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