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Why Employers Should Think Twice About Adding Annuity Payments to Their §401(K) Plan

By Dan Morgan, Esq.[*]

INTRODUCTION

Now that §401(k) plans have replaced traditional pension plans as the overwhelming type of employer-sponsored type of retirement plan, there is a growing concern that many employees are not equipped to make informed and appropriate decisions regarding the retirement savings that they have accumulated in a §401(k) plan. This concern is part of a broader set of societal quandaries, sometimes referred to as a lack of ''financial literacy,'' one of the other manifestations of which is a wide-spread failure of Americans to properly save for retirement at all.[1] As a way of helping to alleviate the financial literacy problem, some have urged increasing the availability of annuity payments in §401(k) plans; however, burdensome requirements under the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA) dissuade many employers from taking this step, and the SECURE Act recently passed by the House does not go far enough in reducing the regulatory challenges.

The investment aspect of improving retirement savings has been addressed, in some measure, during the period prior to retirement, by the inclusion in §401(k) plans of so-called target date, or life cycle, funds. These funds eliminate the need for employee investment decision-making by altering the balance in the funds between equity investments and nonequity investments, in favor of increasing conservatism, based upon an employee's proximity to retirement age. Target date funds have become prevalent as a ''qualified default investment alternative'' under Department of Labor Reg. §2550.404c-5. Under this regulation, which affords a plan's fiduciaries partial protection against claims for breach of fiduciary duty, target date funds are permitted to act as a default investment, where a plan participant fails to make an affirmative election among a §401(k) plan's investment alternatives.

Because of the practical and legal burdens imposed upon 401(k) plan sponsors of keeping track of former employees, many employers require employees to take a lump-sum distribution of their §401(k) plan benefits when the employees reach the plan's retirement age, or upon the attainment of age 70½, which has the effect of shifting entirely to the employee the responsibility of investing their §401(k) account.

Faced with this dynamic, some policy makers have advocated that employees should be encouraged to receive distributions of their §401(k) plan benefits via annuity payments, which are made periodically, for as long as the employees live. Annuity payments have the two-fold advantage of relieving employees of having to determine how to invest their §401(k) benefits after they retire, while at the same time assuring them of receiving at least some retirement income during the entire period of their retirement.

Before annuities can be expected to attain widespread use in §401(k) plans, two obstacles must be overcome. First, employees will need to give up an overwhelming bias in favor of receiving lump-sum distributions. This shift in thinking can only be successful if employees can be persuaded to trade the flexibility of being able to access their retirement benefits at any time for the certainty of receiving a stream of income for life, and relatedly, come to view that certainty as outweighing the concern that they might die prematurely and forfeit part of the value of their plan benefit.

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[1] *See*, Board of Governors of the Federal Reserve System, *Report on the Economic Well-Being of U.S. Households in 2017* (May 2018).

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Assuming employees can be made to see the virtues of foregoing lump-sum distributions, a tall order in the opinion of the author, an employer should not consider making annuity payments a feature of its §401(k) plan without giving serious consideration to the significant legal and administrative practicalities that would be associated with such payments.

ERISA AND THE SECURE ACT

An employer that decides to include annuities as a form of payment under a §401(k) plan must be mindful that the process by which a fiduciary selects annuity contracts has to comply with the prudence and other fiduciary obligations under ERISA.

In this connection, the House of Representatives recently passed The Setting Every Community Up for Retirement Enhancement Act of 2019 (the SECURE Act).[2] The SECURE Act creates a safe harbor that, if properly followed, shields the fiduciaries of a §401(k) plan who select the insurance company that provides annuity contracts to the plan against ERISA breach of fiduciary claims should the insurance company later not be able to satisfy its commitments under the annuity contracts.

The SECURE Act safe harbor is based upon a fiduciary duty safe harbor in DOL Reg. §2550.404a-4. That regulation states that a fiduciary who selects an annuity contractor provider will be considered to have satisfied the prudence standard of ERISA §404(a)(1)(B) if, among other requirements, the fiduciary ''engages in an objective, thorough and analytical search for the purpose of identifying insurers from which to purchase annuities'' and ''appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract.'' The SECURE Act improves upon the DOL regulation safe harbor by laying out specific steps that a §401(k) plan fiduciary should take to assess an insurance company's financial capabilities. A similar provision is included in the Retirement Enhancement and Security Act (RESA), which is currently pending in the Senate.[3]

The conversion of a participant's §401(k) account into an annuity contract raises issues beyond the financial capability of the insurance company issuing the contract. To begin with, there may be fees and other costs charged by the insurance company. Moreover, apart from such expenses, the lifetime income payments that a 401(k) plan participant can expect to receive under an annuity contract are dependent upon two factors, a mortality (life expectancy) assumption and an interest rate assumption. The longer the life expectancy or the lower the interest rate assumed by the insurance company in pricing the annuity contract, the smaller the periodic payments that will be made under the contract.

Insurance companies are not obligated to use particular mortality or interest rate assumptions in determining the amount payable under an annuity contract. Because of this variability, a fiduciary selecting an annuity provider will likely need to obtain the services of an expert to assist in evaluating the market for annuity contracts.

DOL Reg. §2550.404a-4 offers no instruction as to how to assess the appropriateness of the assumptions used to convert a §401(k) plan account balance to an annuity contract, other than to say that the fiduciary must:

> appropriately [consider] the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract.

Similarly, the SECURE Act does not address this aspect of the annuity contract selection process, providing only that:

> Nothing in this subsection shall be construed to require a fiduciary to select the lowest cost contract. A fiduciary may consider the value of a contract, including features and benefits of the contract and attributes of the insurer (including, without limitation, the insurer's financial strength) in conjunction with the cost of the contract.

It should be noted that the SECURE Act's legislative history specifically limits the scope of the ERISA prudence safe harbor to the financial integrity of the insurance company providing the annuity contract:

> The [safe harbor] provision applies to the selection of the insurance company for purposes of determining if the insurer is financially capable of satisfying its obligations under the guaranteed retirement income [annuity] contract. **The provision does not extend to the underlying insurance contract, and therefore the fiduciary must conduct a separate fiduciary analysis of the prudence and terms and conditions of the guaranteed retirement income contract based on present law and guidance**. [Emphasis added.]

In summary, although §401(k) plan fiduciaries, by following the DOL and SECURE Act safe harbors, receive significant protection in the event an insurance company becomes financially unable to make annuity payments, there is nevertheless a substantial amount of other due diligence, outside of the scope of the safe harbors, that fiduciaries will need in undertake to satisfy their duties of oversight under ERISA.

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[2] H.R. 1994, 116th Cong. (2019).

[3] S. 972, 116th Cong. (2019).

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ADMINISTRATIVE COMPLEXITY

The general rule under ERISA and the Internal Revenue Code is that a married participant must receive his or her plan benefits in the form of an annuity for the life of the participant and the participant's spouse (a qualified joint and survivor annuity), unless the participant's spouse consents, pursuant to a formal notice and waiver procedure, to the participant's selection of an alternative form of benefit.[4] This procedure requires a participant's spouse to be provided with detailed information regarding the operation of a joint and survivor annuity and the effect of waiving the survivor portion of the annuity and imposes deadlines on the dissemination of the information and the timing of the spouse's consent waiving the right to receive the survivor annuity.[5] Importantly, for many §401(k) plans, these procedures are applicable to a plan loan to a participant.[6]

A key exception to the qualified joint and survivor annuity procedures applies to a §401(k) plan that requires the participant to name his or her spouse (absent a written consent by the spouse) as beneficiary and does not offer to pay benefits to the participant in the form of annuity payments for the participant's life.[7]

The annuity notice and waiver requirements are a subset of the rules promulgated under the Internal Revenue Code that govern the operation 401(k) plans. These rules, which include eligibility, vesting, and nondiscrimination requirements, and obligate a plan to precisely define (among other things) the compensation to be used under the plan and the timing of the payment of plan benefits, are the subject of IRS audit scrutiny that treats a violation of any of the rules as a basis for retroactively disqualifying a plan, resulting in potentially onerous negative tax consequences to the plan's trust, the plan's sponsoring employer, and the plan's participants.

Although the IRS has published a set of correction methods, currently set forth in IRS Revenue Procedure 2019-19, which a plan offering annuities can avail itself of should it fail to properly obtain required spousal consent, the correction methods are themselves quite complicated.[8]

The practical effect of the regulatory complexity associated with offering annuity payments is that the great majority of employers have eliminated annuities from their §401(k) plans, opting in favor of limiting distributions to lump-sum payments.

CONCLUSION

Absent a groundswell from employees seeking annuity payments from §401(k) plans, an event that is unlikely to occur in the near future, it is difficult to see a compelling business reason for an employer to include annuities in a §401(k) plan. Even if the SECURE Act becomes law, the legal and other compli-ance costs that would follow from the inclusion of an-nuities pose a potential source of regret for an employer who decides to travel down that road.

[4] IRC §401(a)(11)(A), §417(a)(1), §417(a)(2).

[5] IRC §417(a)(3).

[6] IRC §417(a)(4).

[7] IRC §401(a)(11)(B)(iii).

[8] *See* Rev. Proc. 2019-19, §6.04.

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